ECBC

EUROPEAN COVERED BOND **FACT BOOK**

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

EUROPEAN MORTGAGE FEDERATION

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FOREWORD

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

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

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

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

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

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

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

The Covered bond Label and its transparency platform (www.coveredbondlabel.com) are operational since January 2013, providing detailed covered bond market data, comparable cover pool information and legislative details on the various national legal frameworks designed to protect bondholders. As of August 2013, 83 labels were granted to 69 issuers from 14 European Member States, covering over €1.4 trillion of covered bonds outstanding.

In this context, covered bond issuers from these 14 different jurisdictions have come together to develop a National Transparency Template. This provides cover pool information in a harmonised format on the basis of guidelines agreed at European level. The format allows for both the recognition of national specificities and the comparability of information required to facilitate investors' due diligence.

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

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

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

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

FACT BOOK

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

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

Chapter III presents an overview of the legislation and markets in 37 countries. Chapter IV sets out the rating agencies covered bond methodologies and, finally, Chapter V provides a description of trends in the covered bond market as well as a complete set of covered bond statistics.

We welcome the broad range of views expressed in this Fact Book and would like extend our appreciation to the Chairmen of the ECBC "Fact Book" and "Statistics & Data" Working Groups, Mr Wolfgang Kälberer and Mr Florian Eichert respectively, as well as to all Fact Book contributors, whose efforts have once again produced an outstanding edition of the ECBC Fact Book.

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The Covered Bond Voice of the European Mortgage Federation

ABOUT THE ECBC

By Luca Bertalot, ECBC

The European Covered Bond Council (ECBC) is the platform that brings together covered bond market participants including covered bond issuers, analysts, investment bankers, rating agencies and a wide range of interested stakeholders. The ECBC was created by the European Mortgage Federation (EMF) in 2004. As of August 2013, the Council has over 100 members across 25 covered bonds jurisdictions and many different market segments. ECBC members represent over 95% of covered bonds outstanding.

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

ECBC STRUCTURE

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

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

ECBC WORKING GROUPS

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

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

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

> **The Working Group on Statistics and Data**, chaired by Mr Florian Eichert, is responsible for collecting and publishing complete and up-to-date information on issuing activities and volumes outstanding of covered bonds in all market segments. With over 25 different covered bond jurisdictions and numerous issuers, the collection of data is of utmost importance, particularly given that the ECBC data is increasingly viewed as the key source of covered bond statistics.

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

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

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

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

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Caixa Geral de Depósitos S.A.

Citigroup Global Markets Germany

Clifford Chance LLP

Commerzbank Securities

Crédit Agricole Corporate & Investment Bank

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

Crédit Foncier de France

Crédit Mutuel - CIC Home Loan SFH

Crédit Mutuel Arkéa

Credit Suisse

Danish Ship Finance

Danske Bank

DBRS Ratings Limited

Depfa ACS Bank

Deutsche Bank AG

DLR Kredit A/S

DnB NOR Bolligkreditt

Dutch Association of Covered Bond Issuers - DACB

DZ Bank

EAA Covered Bond Bank Plc.

Eurex Bonds

EuroMTS

European AVM Alliance - EAA

Finance Norway - FNO

Fitch Ratings Ltd

GOH Portugal

Goldman Sachs

Grupo BBVA

Gruppo Banca Carige

HSBC Bank Plc.

ICAP Deutschland GmbH
ING Group
Intesa Sanpaolo
Irish Banking Federation - ACS Ireland
JP Morgan
KBC Bank
Landesbank Baden-Württemberg – LBBW
La Banque Postale Home Loan SFH
Linklaters
Lloyds Banking Group
Luxembourg Bankers' Association - ABBL
Moody's
Morgan Stanley Bank AG
Münchener Hypothekenbank eG
Nationwide Building Society
Natixis
Nederlandse Vereniging van Banken - NVB
NIBC Bank N.V.
Nomura International Plc.
Norddeutsche Landesbank Girozentrale
Nordea
Nykredit A/S
OP Mortgage Bank
pbb Deutsche Pfandbriefbank AG
Pfandbrief & Covered Bond Forum Austria
Pfandbriefbank schweizerische Hypothekarinstitute
Realkredit Danmark A/S
Realkreditforeningen
Royal Bank of Canada - RBC
Royal Bank of Scotland - RBS
Santander UK Plc.
SEB AG
SNS Reaal Bank NV
Société Générale Corporate & Investment Banking
Société Générale Société de Crédit Foncier - SG SCF
Standard & Poor's
Svenska Handelsbanken - Stadshypotek
TXS GmbH
UBS
UK Regulated Covered Bond Council - UKRCBC
UniCredit Group
Verband Deutscher Pfandbriefbanken e.V. - vdp

August 2013

CHAPTER 1 - KEY THEMES OF THE YEAR

1.1 INTRODUCTION

By Alexandra Schadow and Stefan Rösch, LBBW

The introduction provides a general impression of the authors' contributions to this year's Fact Book. There is an overview of ECB measures as reaction to the sovereign debt crisis and the changes in regulatory frameworks, which will have a major influence on future market developments. In this context, the behaviour of the various groups of investors regarding the market turbulences is taken into account and rating aspects are discussed. Moreover, alternative long-term funding sources other than mortgage or public sector covered bonds are described. The final topics comprise foreign currency issues and legislative initiatives in new markets.

ECB RESPONDS TO THE SOVEREIGN DEBT CRISIS BY TAKING UNCONVENTIONAL ACTION

"Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." This statement by ECB President Mario Draghi on 26 July 2012 unmistakably underlined the absolute commitment to deploy unconventional measures to the fullest extent possible to stabilise the sovereign debt crisis in Europe. Overall, the ECB is currently clearly pointing the way ahead, which is having a considerable impact on the covered bond market. The effects on financial institutions' funding situation of the central bank's deployment of various monetary policy tools are breaking new ground. The announcement of outright monetary transactions (OMT) and the first covered bond purchase programme (CBPP1) have had the strongest impact on spread tightening and an increase in primary market activity (see Article 1.4). At the same time, well-known patterns – such as government bond spreads being lower than those of covered bonds – have ceased to apply in the wake of the financial crisis. Nevertheless, the risk to covered bonds emanating from macroeconomic trends, which are reflected, inter alia, in the property market (see Article 1.2), has not decoupled from the sovereign. However, there are several reasons as to why this connection has weakened. Covered bond spreads are less volatile than those of government bonds and a rating uplift over the sovereign can result in a lower haircut in ECB repo transactions. In addition, sovereign bonds have suffered haircuts in restructuring measures, while covered bonds have remained unaffected (see Article 1.5). Nevertheless, covered bond spread volatility has increased markedly in recent years. This rise is due to regulatory intervention, institution- and country-specific factors as well as rating changes – primarily downgrades due to the banking crisis. In contrast to government bonds, there are no spread anomalies relative to senior financial bonds. However, in the case of the latter, spreads over covered bonds have risen since mid-2012, above all in countries that are affected by the bail-in rules (see Article 1.6.2).

REGULATION AS A DECISIVE INFLUENCE ON FUTURE DEVELOPMENTS

Besides the influence of central bank intervention, covered bonds are currently subject to considerable changes in the regulatory frameworks. Resolution regime, banking union and the Liikanen report represent significant milestones. In general, the aim is to achieve equal treatment across Europe. This is, however, made difficult by the large number of different legal frameworks for covered bonds. Overall, the rise in regulatory costs will weigh on banks' margins, which means that the role of covered bonds as a cheap funding option will remain crucially important. Accordingly, investors must not have any doubts as to the insolvency remoteness of covered bonds (see Article 1.7). Fulfilment of the Liquidity Coverage Requirement (LCR) is a key criterion that explains why banks have invested in covered bonds more recently. The treatment of covered bonds in connection with the European Banking Authority's (EBA) determination of the LCR has not yet been finally clarified. The assumption is that covered bonds should be classified as highly liquid assets. The objective is to avoid a strong concentration on government bonds in banks' liquidity portfolios. Covered bonds represent an alternative for diversification purposes; their classification by the EBA is likely to be based above all on trading volumes. However, insufficient account is taken of the fact that covered bonds are generally held to maturity (see Article 1.6.1).

MARKET TURBULENCE INFLUENCES INVESTOR BEHAVIOUR

In addition to the effects of financial market activity, the covered bond market is also subject to constant change. Besides new cover assets with risk characteristics that differ from traditional structures and initiatives on the provision of information (e.g. ECBC Covered Bond Label), the final version of the bail-in rules in particular will be crucially important. Investors welcome the expected exclusion of covered bonds from resolution scenarios, since there would otherwise be a risk that covered bonds' reputation as an asset class with a low risk profile would suffer (see Article 1.13.1). The Covered Bond Investor Council (CBIC) represents the interests of investors and ensures a cross-country exchange of views with authorities on current issues. It also seeks to improve transparency and international comparability (see the Key Themes Annex). Finally, the clear and homogeneous structure of the covered bond segment is becoming increasingly fluid – as a result, inter alia, of the growth in soft bullet structures. In contrast to hard bullets, these do not require a clear obligation concerning the redemption date and also offer rating benefits to issuers. As the gap between "expected maturity" and "legal maturity" widens, the difference to pass-through models, in which the repayment takes place step by step depending on incoming liquidity, is decreasing. As a consequence, liquidity risk is also eliminated, which has a stabilising effect on the rating. For investors, by contrast, such structures offer few benefits, since a repayment that takes place long after the "expected maturity" does not have a default character from a rating perspective (see Article 1.8). In primary market issues, banks tend to opt for shorter maturities and lower risks (low mid-swap spreads), while insurance companies, and to some extent funds, prefer long maturities and higher risks. Overall, investors demonstrate a pronounced home bias (see Article 1.13.2). On the one hand, the requirements for a minimum rating imply an additional restriction for investors. On the other hand, the country ceiling represents an insurmountable obstacle for some issuers. In the context of an ongoing decline in top rated covered bond programmes, a survey of issuers was carried out. The latter deals with rating requirements and the methodology applied. At the same time, calls for rating agencies to be regulated are increasing, so that conflicts of interest can be eliminated and supervision improved (see Article 1.9).

LONG-TERM FUNDING OPPORTUNITIES AND ALTERNATIVES

Besides the widespread instruments for long-term secured funding based on mortgage loans or claims against the public sector, further alternatives are available in some markets. There, ships, aircrafts, claims against SMEs and guaranteed export loans may be used as eligible cover assets. By contrast, project finance loans remain excluded. These can be partially refinanced through public sector covered bonds only if state guarantees are available (see Article 1.10). The national differences continue in the funding of budget deficits and public infrastructure projects. Frequently, alternative sources such as regional bonds (e.g. German federal states or autonomous regions in Spain), public agencies or financing through commercial banks are tapped. As a consequence, there is no link between the trend in public budget deficits and issuance volumes of public sector covered bonds (see Article 1.11).

FOREIGN CURRENCY ISSUES AND LEGISLATIVE INITIATIVES IN NEW MARKETS

The heart of the covered bond market continues to beat in the eurozone. Nevertheless, issues from other currency regions such as USD and GBP must also be taken into account. The USD market is dominated largely by issuers from Canada, Australia and Norway. In the first half of the year, issuance volumes were considerably down on the corresponding prior-year period, which was attributable primarily to the temporary absence of Canadian issuers in the wake of a change in the law. By contrast, the GBP market is mostly in the hands of UK issuers, who account for five-sixths of the total. This is mirrored in the share of UK investors, which is almost exactly the same. Despite tight geographical restrictions, issuance totalled GBP 13bn in 2012 – the current record (see Article 1.12.1 and 1.12.2). We would like to end our journey through the covered bond universe by considering the creation of new covered bond markets, in which bonds are issued mainly in local currency. In view of the shrinking markets in Europe, these countries could represent alternatives to some degree. The future prospects of legislative initiatives originating mainly from emerging markets are heavily dependent on the general conditions. The key factors are legal certainty and a clear segregation of cover pools from assets included in the insolvency estate (see Article 1.3).

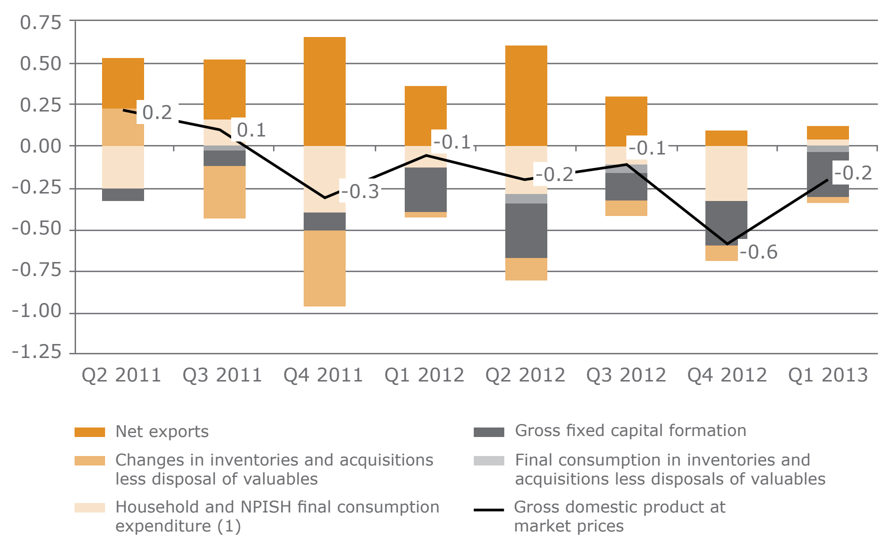
1.2 EU MORTGAGE AND HOUSING MARKETS IN 2012: AN OVERVIEW

By Sylvain Bouyon, European Mortgage Federation

MACROECONOMIC OVERVIEW

In 2012, real GDP in the EU27 turned back to recession (-0.3%), driven by the worsening sovereign-debt crisis in the first half of the year and the ensuing general loss of business and consumer confidence. Despite the improved financial market conditions since the summer 2012, partly resulting from substantial monetary policy easing, the euro area registered its sixth consecutive q-o-q economic recession in Q1 2013 (Figure 1), revealing the weaknesses of the real economy. Among the best performers in the euro area, only Estonia and Slovakia registered real GDP growth above +1% in 2012. As regards the non euro economies, real GDP in domestic currency grew in Poland (+2.0%), Sweden (+1.1%), Romania (+0.7%), the UK (+0.3%) and Bulgaria (+0.8%), while it decreased in Denmark (-0.5%) and Hungary (-1.8%)[1].

> FIGURE 1: CONTRIBUTORS TO THE REAL GDP GROWTH IN THE EURO AREA (Q-O-Q CONTRIBUTION TO REAL GDP GROWTH)



Source: Eurostat
Millions of euros, chain-linked volumes, reference year 2005
(1): NPISH: Non-profit institutions serving households
Please note that the time series have been deseasonalised

Even though exports slowed down noticeably in 2012 (to +2.4% from +6.5% in the previous year), net exports were the only positive contributor to real GDP in the EU27[2], with the German economy generating almost half of the EU27 value. The main reason for this positive performance was the first contraction in imports since 2009, due to poor domestic demand. Nevertheless, net exports have lost momentum since Q2 2012 in the euro area and even provided a negative contribution to the EU27 real GDP in Q4 2012. Amid depressed labour markets,

1 In 2012, growth differentials in the EU27 remained high, as standard deviation for real GDP variation reached 2.4 (vs. 2.7 in 2011 and 2.2 in 2010).
2 In 2012, the contribution of final consumption expenditure of general government to real GDP in the EU27 stood at 0.017%.

with the unemployment rate rising by 1.2 percentage point in the euro area, significant household deleveraging and low consumer confidence, household final consumption expenditure contracted in 2012 by -1.3% in the euro area and -0.7% in the EU27. After growing by +1.5% in 2011, gross fixed capital formation plunged in 2012 in the euro area, mirroring corporate deleveraging and subdued economic prospects. Decreasing exports in Q4 2012 and Q1 2013 might accentuate the contraction in gross fixed capital formation in 2013, since exports are typically one of the main drivers of investment in equipment, and could further delay economic recovery.

In the euro area, reflecting the deep recession in 2009 and the successive rescue interventions in response to the financial crisis, the government to GDP ratio increased from 66.4% in 2007 to 80.0% in 2009 (and from 62.3% to 74.6% respectively in the EU27). This upward trend started to ease in 2010 (85.6%) and reached 93.1% in the euro area in 2012. Further easing is expected in coming years, as a better control of government expenditures and a stronger environmental taxation in several countries reduced the public deficit from -6.2% in 2010 to -3.5% in 2012. However, the increase in the total revenue of governments and the slight contraction in total public expenditure[3] affect real GDP through diverse channels: less final consumption expenditure of general government and less public investment, whereas the heightened tax burden dampens private consumption of household and private investment.

HOUSING MARKETS

Trends in house prices

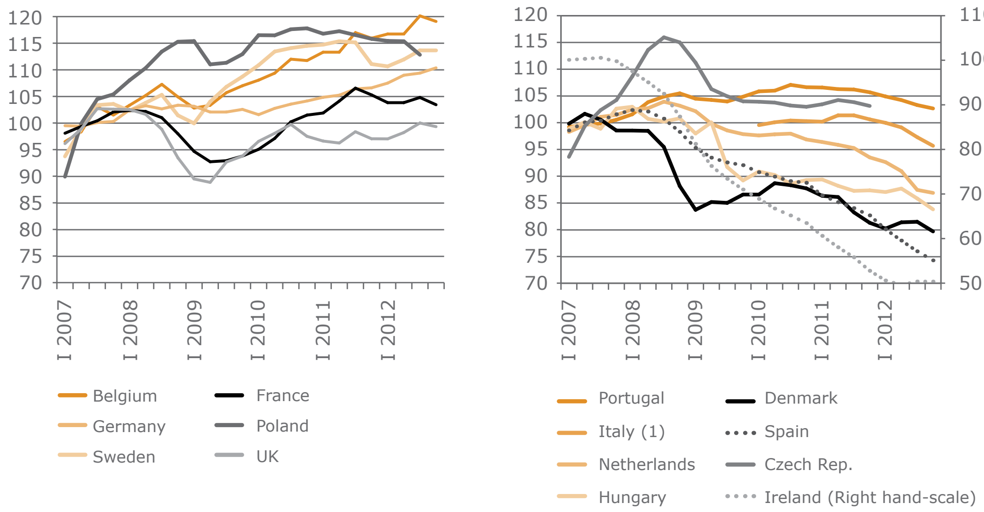
In Q4 2012, based on their annual performances, countries can be linked to three different groups in terms of nominal house prices. Some countries observed noticeable y-o-y growths: Germany (+3.4%), Belgium (+2.7%), the UK (+2.3%) and Sweden (+2.3%). On the other hand, nominal house prices decreased somewhat in France (-1.7%) and Denmark (-1.9%), and substantially in Portugal (-2.7%), Hungary (-4.0%), Ireland (-4.5%), Italy (-4.6%), the Netherlands (-6.9%) and Spain (-10.0%).

Besides the exception of the French market, these differentiated performances are in line with the trends observed between Q2 2009 and Q4 2012 (Figure 2). After decreasing in Q1 2009 in all countries except Poland, nominal house prices developed in a heterogeneous manner till Q4 2012, following two broad trends. In some domestic markets, nominal house prices have followed a positive trend, while in some others prices have moved along a downward path. As a result, in Q4 2012, prices were above their Q2 2009 levels in Belgium (+15%), the UK (+11.5%), Sweden (+9.1%) and Germany (+7.9%); by contrast, they stood below in Portugal (-1.5%), Denmark (-6.3%), the Netherlands (-12.7%), Hungary (-15.9%), Spain (-20.3%) and Ireland (-33.7%). In real terms[4], compared with Q2 2009, house prices increased by +7.0% in Belgium, +5.3% in France, +4.4% in Sweden, +1.3% in Germany and remained stable in the UK. It contracted by -7.2% in Portugal, -11.6% in Denmark, -18.2% in the Netherlands, -26.0% in Spain, -26.5% in Hungary and -33.7% in Ireland.

3 In the euro area, total expenditure of government increased from 49.5% of GDP to 49.8%, while real GDP decreased by -0.6%.

4 The Real House Price Index is the nominal house price (provided by the EMF) adjusted for inflation, using the HICP - All-items excluding housing, water, electricity, gas & other fuels (provided by Eurostat).

> Figure 2: Nominal house prices (2007 = 100)



Source: European Mortgage Federation
Note: (1) 2010 = 100

Noticeable regional differences characterised some national markets at the end of 2012. For example, in France, the overall y-o-y decrease of -1.7% was mainly the result of the contraction recorded in the "province" (i.e. outside of the Paris metropolitan area), since house prices fell by -0.7% in the « Île de France » (the Paris metropolitan area), and -1.0% in Paris. In Romania, prices for apartments increased by +2.0% in Bucharest, while they continued to fall significantly in the rest of the country (by -7.2%). Regarding Sweden, in contrast to the regions of Stockholm and Gothenburg, house prices fell in the region of Malmö, owing to negative spillover effects from housing developments in Copenhagen[5]. Finally, in the UK, house prices were marked by noticeable cross-region differences. The largest increases have been registered in some parts of southern England, especially in London (i.e. +4.9% y-o-y increase). On the other hand, prices in Northern Ireland fell by -8.5% y-o-y.

In addition, there were some differences across national market segments. In Q4 2012, in Belgium, prices contracted by -0.3% y-o-y for houses and increased by +3.4% for apartments. In Denmark, price differentials were also pronounced: despite the robust y-o-y growth registered for owner-occupied flats (+3.9% on a yearly basis), prices for single family homes decreased on average by -2.8% y-o-y. In France, the overall decrease was not spread equally across market segments, since prices for new dwellings increased moderately (by +0.8%), partly mirroring the new regulation boosting construction costs.

Housing supply developments

In 2012, the number of building permits decreased in most EU27 countries for which data is available: Denmark (-34.3%), Spain (-24.3%), Ireland (-23.6%), Hungary (-15.1%) and Poland (-10.2%). Nonetheless, it increased noticeably in Latvia (+16.6%), Belgium (+5.9%) and Germany (+5.0%). Compared to 2007,

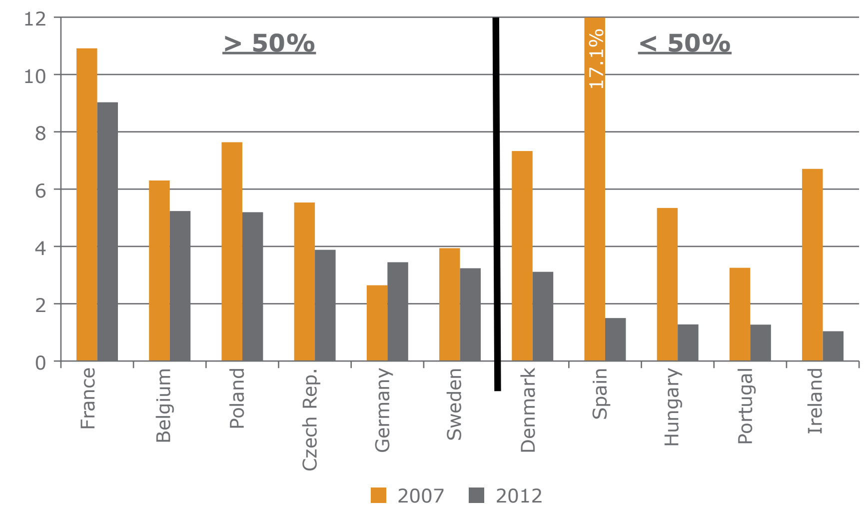
5 Malmö is situated close to Copenhagen, Denmark, and has to a large extent been influenced by the Copenhagen housing market since the construction of the bridge between the two cities in 2000.

the number of building permits per 1,000 inhabitants[6] contracted in all countries[7], albeit at different paces (Figure 3): it decreased by less than half in Belgium, Czech Republic, France, Poland and Sweden, whereas the contraction exceeded this threshold in Denmark, Hungary, Ireland, Portugal and Spain.

One of the main factors behind this heterogeneity across countries proves to be the differentiated dynamics in nominal house prices observed between 2007 and 2012. Indeed, in the first group of countries, with lower contraction in the number of building permits per 1,000 inhabitants, house prices developed rather positively, whereas the other group generally observed long-term downward trends in nominal house prices (Figure 2). Considering yearly variations over the same period, the correlation between nominal housing prices and building permits is estimated at 0.29 (Figure 4). Therefore, it appears that nominal house prices have played a significant role in the activity of the residential construction sector, by shaping the behaviour of investors.

The picture is broadly similar with housing starts and housing completions, although responses of both variables to building permits developments are usually lagged.

> Figure 3: Building permits per 1,000 inhabitants (population over 18)



Source: European Mortgage Federation

6 The population concerns the inhabitants over 18 years old.
7 Excluding Germany.

> FIGURE 4: BUILDING PERMITS AND NOMINAL HOUSE PRICES (2007-2012) (ANNUAL VARIATION, IN %)

Source: European Mortgage Federation

MORTGAGE MARKETS

Outstanding residential mortgage lending

In Q4 2012, the total amount of outstanding mortgage lending in the EU27[8] increased by +2.6% y-o-y (vs. +1.8% in Q4 2011 and +4.3% in Q4 2010), but contracted by -0.3% q-o-q (i.e. the first decrease since Q2 2011 and the largest fall since Q4 2009), and reached 110.1% of its 2007 average.

Nevertheless, the y-o-y figures have been partly distorted by the bilateral nominal exchange rate movements between the Pound Sterling and the euro. While the UK mortgage market grew by +0.3% in 2010; by +0.5% in 2011 and by +1.6% in 2012 in domestic currency, its value in euros rose by +5.6% in 2010, by +0.8% in 2011 and by +5.4% in 2012. As a result, the contribution of the UK to the EU27 mortgage market growth in euro stood at +1.4% in 2010, +0.2% in 2011 and +1.3% in 2012.

In the euro area[9], outstanding loans increased y-o-y by +0.4% in Q4 2012, down from +1.8% in Q4 2011. This slowdown is mainly explained by the 2012 aggregate contribution of Italy and Spain, which was significantly negative in Q4 2012 (-1.1% vs. -0.1% one year earlier). On the other hand, the aggregate contribution of France and Germany remained robust and stood at +1.3% in Q4 2012 (vs. +1.5% in Q4 2011).

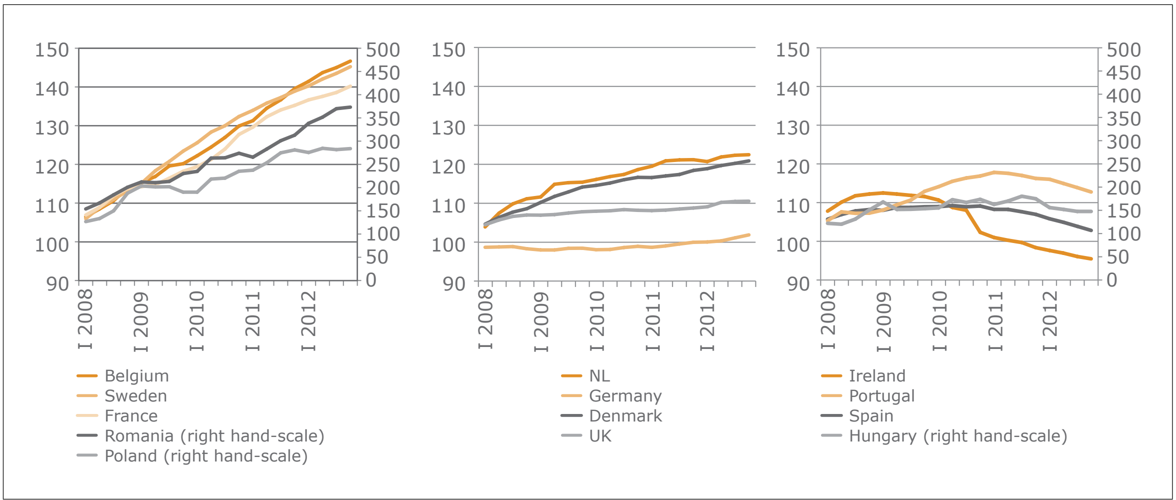
Regarding non-euro economies, in 2012, outstanding mortgage loans generally increased y-o-y in domestic currency: +19.2% in Romania, +4.5% in Sweden, +2.1% in Denmark and +1.0% in Poland.

8 This data does not cover the whole market of the EU27: the sample related to the amount of outstanding residential lending in the EU27 includes Belgium, Denmark, France, Germany, Hungary, Ireland, the Netherlands, Poland, Portugal, Romania, Spain, Sweden and the UK (i.e. 78% of the EU27's GDP at current prices).

9 The sample includes Belgium, France, Germany, Ireland, Italy, the Netherlands, Portugal and Spain (i.e. more than 90% of the euro area's GDP at current prices).

In Q4 2012, for most countries in the EU27, national performances in local currency were broadly in line with previous years (Figure 5). Belgium, France, Romania and Sweden experienced almost continuous robust y-o-y growth in outstanding mortgage loans between Q1 2008 and Q4 2012. Some other domestic mortgage markets also registered growth in the same period, albeit at a slower pace (i.e. Denmark, Germany, the Netherlands and the UK). Finally, within the context of economic recession and household deleveraging, outstanding residential lending has contracted y-o-y for 15 consecutive quarters in Ireland; 7 in Portugal and 6 in Spain.

> Figure 5: Total Outstanding Residential Lending (2007 = 100; in domestic currency)



Source: European Mortgage Federation

Gross residential mortgage lending

Performance in 2012

Gross residential lending in the EU27[10] performed poorly in 2012, as it contracted by -7.4% compared to 2011[11] and stood at only 45.8% of the amount recorded in 2007. However, these figures masked diverse growth dynamics at country level. The main positive contributors were the UK (with +2.4%), mirroring the depreciation of the euro exchange rate, and Denmark (with +4.1%), where remortgaging activity has almost doubled compared to 2011, mainly resulting from the flexibility in the Danish mortgage system and the environment of very low interest rates. By contrast, gross lending in France, Italy and the Netherlands substantially dragged down the EU27 figure, since their cumulative contribution stood at -12.4% in 2012.

Gross lending in the EU27 contracted y-o-y every quarter of 2012: -5.8% in Q1, -10.3% in Q2, -6.6% in Q3 and -6.9% in the last quarter. In quarterly terms, the variation was -10.8%, -0.5%, -0.1% and +4.9%, respectively. Nevertheless, owing to the usual strong seasonal effect in new residential lending, the q-o-q figures were quite different once seasonally adjusted[12]: +7.7% in Q1; -11.7% in Q2; +0.2% in Q3 and -2.6% in Q4.

10 In 2012, the sample includes Belgium, Denmark, France, Hungary, Ireland, Italy, the Netherlands, Portugal, Spain, Sweden and the UK (i.e. around 66% of the EU27's GDP at current prices). Please note that gross lending includes new mortgage loans and external remortgaging (i.e. remortgaging with another bank) in all of these countries except Spain.

11 The inclusion of Germany into the sample softens this decrease, which then stood at -4.1%.

12 The time series have been deseasonalised with E-views 8.0 (Census X-13).

As regards the determinants of gross lending, specific national one-off factors may have distorted several domestic mortgage markets during 2012.

Some of them might have had a positive impact on gross lending. In Ireland, in Q4 2012, there was an increase in activity, as prospective house buyers rushed to meet the 31 December 2012 deadline for the end of tax relief on mortgage interest payments (after that date, relief is not available for new mortgages). In Hungary, under the early repayment scheme[13] (ERS), remortgaging activities rose dramatically in Q1 2012, leading to a y-o-y increase of +187% in gross lending. Nevertheless, the termination of the ERS at the end of Q1 2012 led to a sharp decline in gross lending in Q2 2012. In Poland, a slight revival could be observed in the second half of 2012, as it appeared that households tried to use their last chance to qualify for the subsidised programme "Family on their own" (this scheme was ceased at the end of 2012). In Portugal, in Q4 2012, the first q-o-q increase registered in gross lending since Q2 2010 resulted somewhat from the softening in the implementation of several measures in the financial sector under the "Financial Assistance Programme to Portugal". In Spain, the combination of a rise in VAT for housing purchase and the deletion of subsidies for first-time home buyers, both announced by the government for 1 January 2013, prompted a rise in housing demand during the last months of the year. Finally, in the UK, two one off factors might have raised gross lending in 2012. Firstly, the end of the first-time buyer stamp duty holiday in March had the expected effect of increasing house purchase lending at the end of Q1 2012. Secondly, the introduction by the Bank of England of its new Funding for Lending Scheme (FLS) in August, which aims to increase lending to the real economy by making funding available to banks and Building Societies, might have partly contributed to the gradual easing in mortgage interest rates during the second semester.

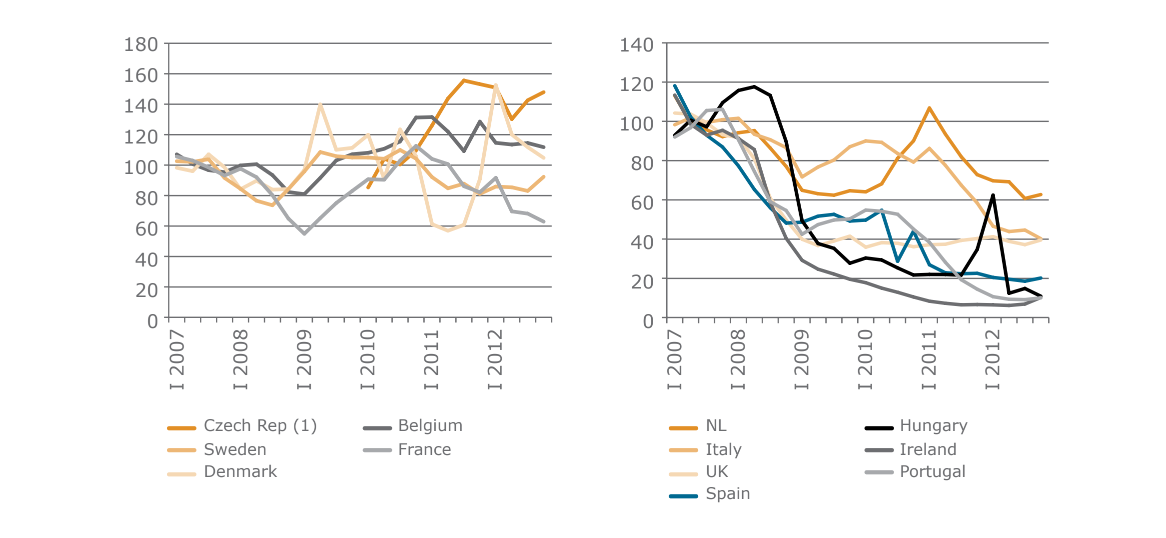
Other one-off factors have probably weighted on the potential gross lending in 2012. In Belgium, the continuous y-o-y decrease registered in both the number of new mortgage lending credit agreements and the amounts of new residential lending can be partly explained by the lagged effects of the cancellation of numerous measures aimed at promoting energy-saving investments at end-2011. In France, the uncertainties surrounding the national elections in April-June and the repercussions of the substantial cuts in expenditures on subsidies in combination with the hikes in some takes, seemed to have induced several distortions on gross lending mainly in Q2 2012. Lastly, regarding Italy, the reintroduction in January 2012 of a wealth tax on real estate property located in Italy (the new tax is called "IMU"- the Italian acronym for "United Municipal Tax") is likely to have further depressed gross mortgage lending throughout 2012.

Trends between 2007 and 2012

When considered from Q1 2007, gross lending dynamics vary widely across countries (Figure 6). The contributing countries can be roughly divided into two groups: one with national mortgage markets where gross lending has followed a positive or stagnant trend between 2007 and 2012; the other composed of countries where gross lending has moved along a downward trend in the same period. The first group includes Belgium and Sweden, as well as Denmark and France. It is worth noting that gross lending in Denmark and France has admittedly followed a positive or stagnant trend between 2007 and 2012, but the time series has been much more volatile in these two countries than in Belgium and Sweden. The second subclass contains Hungary, Ireland, Italy, Portugal, Spain and the UK. Regarding the UK, gross lending did remain below 2008 levels in Q4 2012; nonetheless, contrary to the other countries of the group, the trend has not been downwards since 2009. As shown in Chart 6, gross lending in the UK was flat at a low level between 2009 and 2011, and even increased slowly in 2012.

13 Under the ERS, new HUF loans were issued for repayment of CHF and EUR loans, at a fixed preferential CHF/HUF or EUR/HUF exchange rate.

> FIGURE 6: GROSS RESIDENTIAL LENDING (2007 = 100; IN DOMESTIC CURRENCY)



Source: European Mortgage Federation
Please note that the time series have been deseasonalised
Note: (1): 2010 = 100

Over the 2007-2012 period, different macroeconomic factors could explain this marked heterogeneity across countries in terms of gross lending dynamics. Based on the analyses introduced in the box below, gross domestic product at current prices (which can partially reflect the demand for new loans) has played a key role in this dynamics. However, the findings revealed that nominal house prices could be the most important driver of gross lending in the EU27, perhaps because prices affect gross lending via the channels of both lending standards and demand for new loans.

Which variables can explain gross residential lending?

Gross lending, which includes new loans and remortgaging for most countries[14], is the result of a confrontation between the demand and availability of mortgage loans. Regarding the former, gross domestic product at current prices, which provides an index for the economic activity, is likely to be one of the main drivers, while the level of mortgage interest rates typically reflect the availability of housing credits to households. As modelled by the Bank Lending Survey of the European Central Bank, housing prices affect new businesses via demand and availability of mortgage loans, since both borrowers and lenders will consider housing prices when getting involved in a mortgage contract.

Therefore, gross residential lending GL_{ti} (for the national market i and at the quarter t) is determined by GDP at current prices GDP_{ti}, nominal house prices HP_{ti} and real mortgage interest rates MIR_{ti}, such as:

$$GL_{ti} = GDP_{ti} + HP_{ti} + MIR_{ti} + \varepsilon_{ti}, (1)$$

with ε_t the error terms which are normally distributed.

14 All countries of the sample except Spain.

A static panel regression model will be used to assess which of these variables can explain the trends in gross lending. This regression will be based on a balanced panel model, which includes ten EU27 national markets (i.e. Belgium, Denmark, France, Germany, Hungary, Ireland, Portugal, Spain, Sweden and the UK) and 23 time observations (from the first quarter of 2007 to the third quarter of 2012). The model specification is log-log[15] and time series have been deseasonalised.

To ensure the robustness of the estimated coefficients, the regressions will be conducted with different assumptions. The model specification (1) does not integrate the role played by national structures, which might influence significantly the amount of new businesses. For example, the coefficient for mortgage interest rates might vary noticeably across countries, resulting from the different possibilities for remortgaging. In countries where there are many legal restrictions for remortgaging, the coefficient might be low, while high possibilities for remortgaging could push the coefficient up. Fixed-effect models assist in controlling for this unobserved heterogeneity, when this heterogeneity is constant over time and correlated with exogenous variables. Conversely, random-effect models are used when no fixed effects are assumed.

Another effect which is not considered in equation (1) is related to time: a specific external shock, such as the 2009 crisis might have significantly distorted the amount of gross lending in all countries, no matters the values of the different determinants. As such, a trend correlated to time will be added to the regressions.

Overall, different tests (Figure 7) conclude that the model specification with random-effects, time and individual effects is the most appropriate[16]. The preference for random effects might imply that national specificities do not significantly influence the impact of GDP, nominal house prices and mortgage interest rates on gross residential lending. The importance played by time-effects should mean that some external shocks appearing between Q1 2007 and Q3 2012 might have affected some or all of the domestic mortgage markets of the sample at the same time.

Regarding determinants, the coefficients for nominal house prices and GDP at current prices are estimated at 3.53 and 0.75 respectively and are both significant. This means that 1% increase in house prices will lead to a 3.53% increase in gross residential lending. The elasticity between house prices and gross residential lending is greater than 1 and proves that nominal house prices remain a key determinant of mortgage activities. The coefficient of mortgage interest rates is more ambiguous: it is negative within the fixed-effect model and positive within the random-effect model; however, it is significant only within the former. As a consequence, mortgage interest rates should not be considered as significant within the empirical model developed in this analysis.

15 The dependent variable and the explanatory variables are in logarithmic form.

16 The significance of individual and time effects is tested by F-tests, whereas the Hausman (1979) specification test evaluates the significance of random effects versus fixed effects (these tests are conducted with Eviews 8.0).

> Figure 7: Contribution of different variables to the variation in gross residential lending (time and individual effect)

		Random effect	Fixed effect
Endogenous Variable	GRM_{ti}		
Exogenous variables	Constant	-6.991** (1.022)	-29.341** (4.696)
	NHP_{ti}	3.528** (0.282)	1.700** (0.350)
	RMR_{ti}	0.165 (0.113)	-0.483** (0.127)
	$CrrtGDP_{ti}$	0.752** (0.170)	5.558** (0.948)
R-squared		0.492	0.968
Adjusted R-squared		0.486	0.963

Note: * and ** denote significance at 5% and 1% respectively

Interest rates' developments

Amid poor macroeconomic performance and fading inflationary pressures, most central banks across the EU lowered their policy rates in 2012. In the euro area, annual headline inflation (excluding energy and unprocessed food) gradually lessened in 2012 to stand at +1.6% in Q4 2012, while real GDP contracted y-o-y every quarter of 2012, reflecting continuous decline in domestic demand. Against this backdrop, the ECB cut its policy rate on 11 July 2012 to the all-time low of 0.75%. In response to abating inflation pressures and a noticeable GDP contraction in 2012, the Czech Central Bank reduced its repo rate to historical lows (i.e. to 0.05%). As regards Sweden, contained inflation pressures and the pronounced slowdown in real GDP growth (+1.0% in 2012 vs. +3.7% in 2011) led the Swedish Central Bank to cut its repo rate by a total of 75 bps in 2012. In a context of marked stagflation, with a noticeable GDP decrease and persistently high inflation, the Hungarian Central Bank lowered the base rate eleven times between Q1 2012 and Q2 2013, decreasing the rate from 7.00% to 4.25%. Finally, in Poland, the rapid easing in inflation pressures and real GDP growth in the second half of 2012 prompted the Polish Central Bank to reduce its reference rate five times in Q4 2012 and Q1 2013, by a total of 150 bps.

As a consequence of these monetary policy actions, in Q4 2012, representative mortgage rates recorded significant q-o-q decreases, with the largest average reduction for the EMF Members[17] since Q2 2011 (-21 bps in Q4 2012 vs. -14 bps in Q3 2012 and -17 bps in Q2 2012). In comparison with Q4 2011, representative mortgage rates decreased in all countries except Belgium (unchanged), the UK[18] (+14 bps) and Ireland (+45 bps). The decrease was above 50 bps in Romania (-132 bps); Sweden (-129 bps); Spain (-81 bps); Portugal (-80 bps); Germany (-76 bps); Denmark (-70 bps); France (-60 bps) and Hungary (-59 bps).

17 The sample contains Belgium, Denmark, France, Germany, Hungary, Ireland, Italy, the Netherlands, Poland, Portugal, Romania, Spain Sweden and the United Kingdom (i.e. more than 94% of the EU27's outstanding residential lending).

18 In the UK, while mortgage interest rates in Q4 2012 were higher than in Q4 2011, they have been on a downward path since the summer 2012.

1.3 COVERED BONDS GOING GLOBAL: FORTHCOMING LEGISLATION AND COVERED BOND TOOLKIT FOR REGULATORS IN EMERGING MARKETS

By Olivier Hassler, World Bank consultant
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THE COVERED BOND MAP GOES BEYOND EUROPE OR DEVELOPED MARKETS

As the popularity/attractiveness of covered bonds stretches beyond the boundaries of Europe and North America (developed Western countries), the need for a comprehensive framework of laws has spread to new markets in Latin America and Asia. Covered bond laws already exist in numerous countries in these regions and have done so for some time; for e.g., in Chile, Colombia, Costa Rica, Panama and Paraguay. Frameworks have been more sporadically established in Asia, in particular in Azerbaijan, Mongolia and Turkey.

An expansion trend has emerged[1]. Recently, certain countries have developed their own covered bond frameworks; for instance, Uruguay (2009) and Peru (2010-11) or have added to their existing frameworks, such as Chile (2010-12). Others are in the process of establishing new systems: Brazil, India, South Korea[2], Mexico and Morocco.

ACTIVE MARKETS ARE, HOWEVER, A SMALL PART OF THE LEGAL MAP. BROADER CONDITIONS PLAY A BIG ROLE IN THE SUCCESS OF COVERED BONDS

Few countries where covered bonds are available actually make use of the instrument – Chile is by far the pioneer, not only legally but also economically (see Annex I). This is because its success has not only relied on a specific legal and regulatory framework. Broader conditions, linked to lending or capital markets, must be met for the market to take off.

These conditions are in substance similar to the ones required in mature markets.

> One example is the problem of depositors' structural subordination – in many countries, the banking law gives depositors priority over other creditors and restricts the possibility for banks to secure debt by loans. The solutions that have been devised or that are being contemplated follow approaches used in mature markets. In Mexico, the draft law links the issuance of covered bonds to minimum solvency levels (see Annex II). In the Moroccan draft, there is a ceiling to the bonds relative to the issuer's assets. The Peruvian law limits the overcollateralization level to 2% of these assets. The covered bond system that is being prepared in India considers beginning by targeting specialized Housing Finance Companies regulated by the National Housing Bank.

> Another example of general issue is the super-privilege that is often granted to wage and tax creditors. Policy makers must decide on how to combine this rank with the protection of covered bondholders in insolvency proceedings – a question applicable in any context but that is maybe more difficult to solve politically where the novelty of covered bonds limits the awareness of their benefits.

However, many conditions exist that may be taken for granted in mature markets but hat cannot be assumed to be in place in emerging or developing economies and which require special attention and solutions. The following sections focus on critical pre-requisites that can be difficult to meet, but without which the effectiveness of a covered bond system is likely to be reduced.

1 The Mortgage Refinance Facility model –in use since many years for instance by Malaysia , Jordan, Algeria –, which is also rapidly expanding, is not considered here

2 South Korea already uses general law based covered bonds

THE NEED FOR A CONDUCIVE BACKGROUND

A reasonably stable macroeconomic environment is first required for the successful introduction of covered bonds, as for long-term finance in general. Indexation can be a way to attract investors despite an inflationary context and, for instance, it was a definite factor of success in Chile. It is, however, efficient insofar as it dampens fears of future inflation, but if inflation remains high, numerous experiences show that it may have opposite consequences and might create risks, in particular on the borrowers' side. It therefore does not remove the need for monetary stability.

The quality of the lending market infrastructure is a critical prerequisite. Since covered bonds are backed by loans, their risk profile not only relies on issuers' standing, but also on the soundness of the underlying portfolios. While Lending standards set contractually or by regulatory frameworks are, of course, important in this respect, the robustness of a system will be determined largely by the lending environment and the tools for adequate risk management. In the case of mortgage lending, the main elements to assess when developing covered bonds are as follows:

> The reliability of the land registration and titling systems: Weaknesses in this fundamental component are frequent in developing countries. Covered bonds cannot rely on uncertain property rights, unregistered transfers and flawed mortgage administration. When mortgage bonds were introduced in Chile in the 19th century, land registries had started being established throughout the country. One aspect of the issue is specific to federally structured countries: land registries are often governed and managed by individual states, with varying degrees of efficiency and sometimes widely different transaction costs. This can be an obstacle given the dynamic nature of covered pools, especially in an Special Purpose Vehicle (SPV) / Special Purpose Entity (SPE) system involving assignment or sales of loans between the lender and the guaranteeing entity.

> The credibility of mortgage rights: Foreclosures generally imply long and costly processes, often face cultural resistance and can lead to significant losses in the absence of a liquid property market. Still, it is of utmost importance for the perception of covered bonds as secured instruments that mortgage enforcement be a credible coercion tool and has a true impact on repayment discipline. In this instance, again, Chile showed the way very early by organizing a special, streamlined foreclosure process in the case of loans that were made in the form of Letras de Credito Hipotecario[3].

> The transparency of the real estate market and the existence of reliable appraisal capacities. Valuation is a critical function given the role of Loan to Value (LTVs) for covered bonds at origination and, as much as possible, on an ongoing basis. This requires a well-organized and supervised appraisers industry, whose efficiency is in turn dependent on real estate market information. In particular, housing price indexes are far from being commonly available in the emerging world. India, Mexico and Morocco are countries in which indexes have been developed by the Central Bank or Housing Finance Authorities prior to the preparation of a covered bond system.

A minimum development level of the bond market is necessary. This apparently obvious condition encompasses several criteria that are often far from being met:

> A critical mass of institutional investors: Many emerging countries lack a broad institutional investor base, which makes the introduction of covered bonds premature. Targeting foreign investors to replace them is not really an option in the early stage of development. Independently of currency risk, it is unlikely that foreigners would be interested in an instrument that has not been well tested first domestically and which

3 In particular the original law strictly limits the grounds for contesting a proceeding. The mechanism has been extended later on

does not offer exit options in the local market[4]. As was the case in Chile in the early 1980s, or today for instance in India, Morocco or probably soon in Romania following the 2010 reform, the existence or the promotion of large pension funds is critical for the success of the new instrument.

a) A significant yield curve against which relatively long dated bonds can be priced,

b) Enough room for private sector debt, which must not be crowded out by government issues.

THE NEED FOR COVERED BONDS TO ADD VALUE

Covered bonds must meet definite needs among lenders and fit into the market structure. Incentives to mobilize funding from capital markets can be weak – lenders may have a low loans-to-deposit ratio and be very liquid, and only lend on an adjustable rate basis. Prudential rules aimed at limiting asset/liability mismatches are, of course, an important source of motivation in this respect. Also, the size and financial standing of institutions are relevant factors, unlike (theoretically) for securitization since covered bonds are general debt obligation of the issuer. Furthermore, the legal framework must allow the issuance of covered bonds by those institutions which need it and for the types of loan that are in demand.

They must also match investors' strategies and capacities. There must be enough investors with long-term liabilities and a need to diversify portfolios out of direct real estate investment or lending. One advantage of covered bonds relative to Mortgage Backed Securities (MBS) is their simplicity. In new markets, the analytical capacities required for the risk assessment and estimation of market values of structured products may not be accessible to investors due to insufficient expertise, lack of data or ways to access data, and the cost of valuation tools. This should be a transitional situation until markets reach certain levels of maturity and sophistication, but still one to be taken into account.

Covered bonds must bring clear benefits relative to existing instruments. In emerging markets where covered bonds are legally available but are not used one explanation can be the competition from other funding instruments. While, in mature markets, a wide spectrum of investors with diversified needs allows instruments with similar purposes to coexist, in small or new markets, covered bonds must be clearly distinct from, and complementary to, existing investment vehicles. In quite a few Latin American countries such as Brazil, Paraguay, Peru or Uruguay, several types of mortgage-related securities are available, including MBS and on-balance sheet debt instruments. Brazil in particular has developed multiple options to fund housing. There are transferable mortgage loans[5], two securitization instruments[6], two types of on-balance sheet mortgage bonds[7], and Real Estate Investment Trusts[8]. The upcoming "Cedulas de Credito Garantidas" will have to bring definite benefits that are not already available in the market. This is likely, given the standardization and rationalization impact they will have and the strengthened security they will offer[9].

Colombia provides another example of the importance of complementarities as a success factor. The Colombian housing finance market represents a low 4.5 % of GDP, but mortgage securitization is highly developed in relative terms (25% of the market). Bonos Hipotecarios are handicapped by a compulsory pass-through structure which makes them very similar to MBS[10]. A change of legal provision would help covered bonds fill a gap in the instrument profiles.

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4 The situation is of course different if the country is part of a monetary zone with a supranational bond market as in the Euro zone

5 Cedulas de Crédito Imobiliàrio

6 Certificados de Recebiveis imobiliàrios (CRI) and Fundos de Investimento em Direitos Creditórios (FIDC)

7 Letras Hipotecarias and Letras de Crédito Imobiliàrio

8 Fundos de Investimento Imobiliàrio, used in particular for funding real estate developments

9 LH and LCI, although backed by pools of loans, do not provide investors with special privileges in case of bankruptcy

10 In addition, Bonos Hipotecarios must be indexed, whereas loans in Peso represent the vast majority of new lending now- and can be securitized

Mortgage Covered bonds in Colombia (Bonos Hipotecarios)

> Legal background: Law 546 of July 1999, which overhauled the mortgage finance system. The same law also established a securitization framework (Titulos Hipotecarios). With further regulation of the Superintendencia de Valores, both instruments were integrated into the securities law in 2010.

> Loans eligibility criteria: Mortgage lending is strictly regulated in Colombia, and the same quality norms apply to loans funded by Bonos Hipotecarios as to other loans: first rank mortgages; LTVs limited to 70% or 80% for ordinary loans and loans of social interest, respectively; the debt servicing-to-income ratio limited by law to 30%; and mandatory property insurance.

> Structure of securities: Bonos must be amortized in parallel with the expected amortization schedule of underlying loan portfolios; loan prepayments – voluntary or as a result of foreclosures – are passed on to investors. The law also stipulates that they must be indexed.

> Cover pool monitor: Issuers must contract a portfolio administrator to provide custody and servicing services. In particular, the administrator determines and receives payments from borrowers, maintains accounts, conducts foreclosure proceedings, and reports to the capital market regulator and the bondholders. An independent specific controller oversees the administrators' activity, mostly with respect to market information.

> Protection against insolvency: There is no overcollateralization requirement; Bonos Hipotecarios must only have a shorter maturity than the loans they fund. Cover assets are earmarked and kept out of the general estate in case of insolvency. In the event of liquidation, bondholders must decide whether to dispose of the mortgage assets and prepay the bonds, or transfer them to another credit institution or a fiduciary company that services portfolios. If these solutions cannot be implemented within 90 days, the underlying loans are transferred back to the insolvency estate.

Pricing issues can hinder the acceptance of covered bonds. It can be expected that the introduction of a new instrument requires a price discovery process, with iterations before the market finds equilibrium[11]. Nevertheless, more structural issues can be at play in young markets. A major one can be investors' lack of sensitivity to credit risk. When there are only a few investors and a few lenders, who moreover have established business relationships over a long period, investors may not be willing to suddenly pay a higher price for heightened security. Also, price formation in such markets may be affected by distortions – for instance, due to an unlevel playing field between lenders that are not subject to the same profitability or capital constraints.

Market imperfections can be addressed for a large part by recognizing, through regulation, the value of the special security attached to covered bonds. It is critical that the introduction of the instrument be paralleled by adjustments in the investment rules and prudential treatments applicable to institutional investors and banks respectively.

THE NEED OF STRONG CONFIDENCE IN THE RESILIENCE TO STRESSED SITUATIONS

The design of efficient legal frameworks may require political will. Two basic features must be recognized by policy makers and regulators as the essence of covered bonds:

> Exemption of the general bankruptcy law. The segregation from other assets and the priority right of bond holders on the cover pool must be stipulated by law – in the case of a specific law based system

11 See for instance in Australia, in the spring 2013, the renewed interest of investors for MBS following the fall of spreads for covered bonds that had gotten off a buoyant start

– which means amending some of the existing provisions in the country's legal framework. Even in the case of structured covered bonds, the clean break between the guaranteeing SPV that holds the cover assets and the issuer must be absolutely unquestionable, be it established by regulation or certified by legal opinions[12].

> Insulation from bail-in risks. In several parts of the world, recovery and resolution regimes have been passed or are being prepared following the global financial crisis and the subsequent costly bail-outs of banks. Including covered bonds in the list of bail-in-able debt would undermine the basic logic behind the instrument – i.e. provide insulation from issuers' insolvency except in the case of default or liquidation, with the correlative principle of non-acceleration of maturities. The bail-in framework recently drafted by the Brazilian Central Bank recognizes this, and explicitly excludes secured debt from its scope.

Adopting these specific treatments requires adopting a clear, but not always easy, stance regarding the ranking of covered bond holders vis-à-vis other creditors.

Careful attention must be given to more specific technical legal aspects. Critical for the robustness of a covered bond system are for instance:

> The legal strength of overcollateralization as part of the cover pool above the minimum level set by law, including additional assets brought into the cover pool during the life of the bonds.

> Post-insolvency, the ability of the cover pool administrator to borrow for the purpose of matching catch flows and refinancing maturing bonds.

The credibility of investors' protection mechanism also depends on the market environment. Besides a strong legal design, operational conditions must make likely that, in the event of insolvency, the mechanism will be effective. Some of the main aspects that need to be carefully assessed in a nascent market are:

> The quality of the monitoring and supervision arrangements. Monitor agents fulfil a particularly sensitive function given the dynamic nature of cover pools. They must have the capacity to perform loan-by-loan checks, be independent from lenders as well as transactions arrangers, and be subject to governance rules. Bank supervisors must be able to take over additional responsibilities.

> The availability of alternative institutions susceptible to buy or service cover pools in the hypothesis of their separation from a failed issuer. This is probably one of the most difficult conditions to meet in a small market. For this reason, covered bonds may not be an efficient option if the size of the mortgage market is very limited and the number of lenders very small.

> The strength and fiscal soundness of the government. In practice, the security mechanism of covered bonds has never been really tested. This is because governments have always stepped in to rescue ailing issuers before its enforcement. Rating agencies and investors keep this fact in mind. The likelihood of the readiness and capacity of a government to help resolve an insolvent issuer in an orderly way remains an important factor determining the credibility of a covered bond system.

CONCLUSIONS ON MARKET CONSIDERATION FOR FUTURE SUCCESS

The appetite for covered bonds issued under new legal frameworks is large, especially as the European market has started to shrink. Some investors have global funds and expertise enabling them to diversify worldwide. That said, they require minimum quality standards when considering investing:

12 The clean break principle must include the non-contagion of the lender's bankruptcy to the SPV/ SPE , even if their accounts are consolidated

- A clear definition of the covered bond ensuring that the instrument provides dual recourse, preferential rights over specific assets and bankruptcy segregation. Enforcement of covered bond holders' rights must also be free of any legal hurdle.
- Prudent valuation based on reliable indices/methods conducted on a frequent basis or in case of any material variation in property prices. "Material" should be defined to prevent any uncertainty, so should the different tests performed on the cover pool to ensure sufficient collateral or limit cash flow mismatching.
- A detailed process in case of issuer bankruptcy including answers to the following questions: how is insolvency defined? Who takes over? What are the powers and accountability of the cover pool administrator? What is the role of the supervisors? Is voluntary OC protected or not?
- Transparent reporting requirements easily available on a regular basis (international standards are typically monthly or quarterly), together with independent monitors to ensure the adequacy of the information and of the applied tests. In that respect, the ECBC's Covered Bond Label defines minimum quality standards – both in terms of reporting and collateral type (e.g., excluding non-traditional assets) – which might be a useful benchmark for new markets as a starting point.
- Liquidity and support from domestic market participants (investors, issuers, regulators) signalling the systemic importance of the product or ownership. As such, launching covered bonds, first nationally and, once well-established, internationally gives some degree of comfort.
- Pricing of the covered bonds relative to banks' full debt structure and/or sovereign bonds. When assessing their risk/reward, risks linked to the macroeconomic/regulatory environment, banking sector and underlying collateral are key. The maturity and other characteristics of the covered bonds also drive the investor base.

Annex II summarises the main features of legislations recently finalised or under development.

ANNEX I - COVERED BONDS IN CHILE

Chile has one of the oldest covered bond systems in the world. The history of the instrument is a good illustration of the conditions of its successful deployment, and the impact of changes in an evolving economy.

Origin

Mortgage bonds were introduced in 1855 in Chile, through a law that also created a state housing bank, the Caja de Crédito Hipotecario, and granted to it special foreclosure rights. German immigrants had been settling for a few years in the region of Valdivia, their port of entry, where they developed breweries, steel mills and farms. They introduced the concept of Pfandbrief for agricultural investments. In exchange for mortgage rights, the housing bank gave property owners letters of credit – Letras de Crédito Hipotecario (or LCH) – for up to half the value of the property, which were then sold on the bond market.

The system operated smoothly until the 1930s economic depression that resulted in heavy delinquencies, defaults or restructuring of outstanding bonds and the disappearance of this long-term financial instrument. The Chilean housing finance system was then only based on savings institutions, either social security funds (cajas de previsión) or saving and loans that merged with CCH to give birth to the Banco del Estado in 1953. In addition, a new private savings and loans system was developed in the 1960s. The country, however, entered a phase of high macroeconomic instability, and the new system collapsed in the mid-seventies, a victim of inflation, imprudent lending to developers, and deregulation[13].

13 The funding of these institutions (SINAPS) came from savings deposits that enjoyed the exclusive right to be indexed. The removal of this monopoly in the mid-1970s, while SINAPS had long term, immobilized assets, triggered their quasi instantaneous demise.

In 1977, to restart housing finance, the financial community – both the industry and regulators – decided to revitalize the largely forgotten mortgage bonds. To help the re-introduction, the central bank dedicated a fund to the purchase of LCH, which was the main investor in a ramp-up phase. Then the mobilization of savings developed robustly due to the creation of fully funded pension funds in 1980[14]; and the indexation of LCH, through the well-accepted and generally used accounting currency unit, the Unidad de Fomento[15]. Together, these created an environment conducive to long-term investments. Since the new pension funds and related life insurance schemes had limited investment opportunities and, in particular, were prevented from buying stocks originally, LCH became a privileged investment vehicle, resulting in a huge inflow of capital into the housing sector, a remarkable lengthening of maturities – quickly up to 20 years with fixed real interest rates, a duration that was extremely rare worldwide at that time – and a strong development of housing finance. Housing loans now represent 20% of national GDP, making Chile one of the deepest penetrated markets in emerging economies.

Basic features of Letras de Credito Hipotecario

Chile – along with Denmark – is probably the only enduring example of the original Pfandbrief system based on loans extended in the form of bonds, resulting in the identity between individual loans and bonds and a strict pass-through mechanism. The main features are described below:

> Issuers: commercial banks, finance companies, regulated savings cooperatives. In practice, only commercial banks.

> Purposes: residential or other real estate investment – two separate categories of bonds.

> Maximum loan-to-value ratio: 75% (60% for loans denominated in foreign currency) in principle. However, the limit has been lifted to 100% for loans to the best-rated borrowers by the best-rated banks (central bank grading scale). LCH with a higher LTV are pooled in specific series.

> Maximum debt-to-income ratio: 25%, in case of housing valued at less than USD135,000[16] equivalent.

> Register: LCH are recorded in a register together with the earmarked loans that they represent. The banking regulator, SBIF, monitors the register and has the power to take over its maintenance if needed.

> Cash-flow matching: because the delivery of bonds is the way to disburse loans, LCH are pass-through securities. Lenders are immune to liquidity and interest rate risks, including prepayment risk. Their compensation comes from a fixed fee added to the interest paid on bonds.

> Credit risk: lenders keep the credit risk and pay the cash flows due to LCH holders even when underlying loans are non-performing. The execution of mortgages leads to the prepayment of LCH, but the loss is incurred by their issuer. Issuers may also retire bonds in case of a strong depreciation (60%) of the securing properties if loans are impaired.

> Issuance: LCH are pooled in series defined by common features, purposes, types of LTV, periodicity of payment, amortization process. They are issued on tap, with no distinction between primary and secondary sales

> Protection against the issuer's insolvency: mortgage bonds enjoy special treatment in the case of voluntary, as well as forced bankruptcy[17]. Underlying loans, together with the corresponding debt, are sold

14 Chile was one of the first countries to develop pillar II pension funds

15 Inflation was above 20% nearly every year until l 1992 in Chile

16 3,000 Unidades de Fomento, the indexed currency unit

17 General Banking Law, art. 125,126 and 135

separately from other assets through adjudication, implying a risk of loss for bondholders, but with a relative safety net. If the adjudication results are too unfavourable, (i) in a debt reorganization, the conditions of the agreement with creditors can apply, and (ii) in a winding-down of the issuer, the mortgage loans can be reintegrated into the general bankruptcy estate.

> Regulation: mortgage bonds are governed by the banking law. The regulation is split between the central bank (lending standards, information of borrowers and investors) and the Superintendencia de Bancos e Instituciones Financieras (conditions for issuances, mortgage loan registries, and the linkage between loans and bonds). SBIF supervises compliance with all applicable norms.

Decline

At the end of the 1990s, the market share of LCH started declining. Another category of loans, endorsable mortgages (Mutuos Hipotecarios Endosables) developed, especially with the emergence of securitization for which they provide an easy, ready-made basis. Mostly, mortgage loans with little specific regulation (Mutuos Hipotecarios) became the major form of housing loans. Term funding was provided through the issue of unsecured "Bonos Bancarios". LCH, which represented over 82% of the stock of housing loans in 1997, fell to 27% 10 years later and to less than 10% at the end of 2012 – in a market that basically doubled between 2007 and 2012[18]. Three main factors can explain this fall:

> The lack of flexibility of LCH due (i) to its basic structure – the bonds can only finance new loans and, in particular, do not allow loan restructuring; moreover, the pipeline risk[19] is not negligible; (ii) to the lack of standardization with bonds scattered between multiple series; and (iii) perhaps to very complex regulation.

> A wave of pre-payment in the early 2000s, while the prepayment option had not been fully priced.

> The limited credit enhancement achieved by the system relatively to unsecured debt – roughly no rating uplift in about half of the cases, one notch upwards in the other half. This is a consequence of (i) a structure in which the issuer is mostly the guarantor for the cash-flows owed to investors[20], and (ii) the bail-in-able character of these securities.

In 2010, a change in the banking law (art. 69) established a new type of bonds besides LCH, which became operational in October 2012 after a secondary regulation was passed by the Central Bank and SBIF. The instrument, "Bonos Hipotecarios sin Garantia Especial[21]", or Bonos Hipotecarios, aims to remedy primarily the lack of flexibility of LCH, and better protect investors against the prepayment risk. The main features of the new covered bonds are:

> Issuers: banks[22]

> Purpose: residential mortgage loans, for new investments or the refinancing of existing loans.

> Loan eligibility criteria: 80% maximum LTV, 25% maximum debt-to-income ratio.

> Link between loans and bonds: each issue, or series of issues with the same characteristics, is backed by a cover pool made of the loans funded by them, and recorded in a special register. Issuances of Bonos come first, only loans originated afterwards can be allocated to the cover pools – there is a 18 month period to do so, otherwise Bonos must be prepaid

18 From roughly USD 25 billion to 50billion

19 The exact amount of loans depends on the bond market fluctuations. The government had designed a specific subsidy to cover part of this risk. Banks are now allowed to pre-set the amount and assume the risk

20 There is no overcollateralization and capital allocation as in the Danish capital center system

21 A reference to the fact that bondholders do not hold the security interest in the underlying properties

22 94% of the mortgage market at the end of 2012

> Balance principle: the nominal amount of cover assets must always be at least equal to the outstanding amount of related Bonos. Loans in arrears by more than 10 instalments or which are not 100% secured following the depreciation of the underlying properties must be replaced, as must be prepaid loans. The regulation does not stipulate a specific relationship between interest rates on loans and bonds.

> Substitute assets: proceeds of issues can be invested in Treasury or Central bank bonds, other prime-quality debt instruments and bank deposits, while the loans to be included in cover pools are progressively originated. At any time afterwards, these assets can represent up to 10% of cover pools.

> Protection against insolvency: The treatment of Bonos Hipotecarios in the case of voluntary or forced bankruptcy is the same as for Letras de Credito.

ANNEX II - NEW LEGISLATIONS AT A GLANCE

>Figure 1: Recent Frameworks

	Peru	Uruguay	Chile
Product name	Bonos Hipotecarios Cubiertos	Notas de Credito Hipotecarias	Bonos Hipotecarios
Type of issuer	Financial Institutions (FIs) authorized to lend for housing. Pooling of issues possible (Creditos Puente)	All FIs authorized to provide mortgage loans	Banks
Cover asset holder	Issuer (register)	Issuer (register)	Issuer (register)
Supervision	Banking regulator (SuperIntendencia de Banca, Seguros y Administradores de Fondos de Pensiones)	Central Bank	TBC
Eligible assets	Residential mortgages basically (NPL excluded)	Residential mortgage loans	Residential mortgage loans for new investments or the refinancing of existing loans (NPLs excluded)
Max LTV	80%	90%	80% (also 25% max debt-to-income ratio)
Min OC	10%, without exceeding 2% of the issuer's assets in case of deposit taking institutions	5.3%. Moreover, loans enter the cover pool for an amount capped at 70% of the value of the property	None
Monitoring mechanism	Independent monitoring agent, reporting to the Superintendencia	TBC	TBC
Mechanism in case of Insolvency	Cover pool segregated from the bankruptcy estate, transferred under the conditions decided by the Bondholders Assembly.	Transfer of eligible assets up to 105.3%of NCH nominal value to a Recovery Fund managed by the Deposit Insurer, which can sell it independently. Shortfalls are reintegrated in the bankruptcy estate	Underlying loans, together with the corresponding debt, are sold separately from other assets through adjudication, implying a risk of loss for bondholders, but with a relative safety net
Issuance limit	Indirectly, through the OC limit	None	None

* Financial institution with equity capital >KWR100bn and a 10% BIS ratio with adequate risk management
Sources: official legal sources, national authorities web sites, World Bank reports

>Figure 2: Frameworks under development as of June 2013

	Brazil	Mexico	Morocco	South Korea
Product name	Cédulas de Crédito Garantidas	TBD	Obligations Sécurisées	Covered bonds
Type of issuer	Financial institutions Authorized by the Central Bank	Regulated Financial Institutions meeting minimum solvency standards - CAR > 12%, tier 1 > 8%	Banks	Banks, Korea Housing Finance Corporation, Korea Finance Corporation, and other equivalent institutions designated by Presidential Decree*
Cover asset holder	TBC	Issuer for special law based CBs (register) or SPV model	Issuer (register)	Issuer (register)
Supervision	TBC	CNBV (banks & capital market regulator)	Central Bank	Financial Services Commission
Eligible assets	Real estate loans, public sector loans, loans to other economic sector, leasing	Mortgage loans & loans for infrastructure. Fixed rate	1) Mortgage loans (commercial real estate possible up to 10% of the cover pool) 2) loans to local Authority (separate register)	Residential mortgages and central/local government loans
Max LTV	TBC	80%	80% (residential), 60% (commercial), more if financial guarantees	70%
Min OC	TBC	5%	5% (both in nominal and Net Present Value terms)	5%
Monitoring mechanism	Collateral Agent	Independent monitoring agent	Specific cover pool controller	Independent auditor
Mechanism in case of Insolvency	Segregated pool of assets, for the exclusive benefits of CCG holders, insulated from bankruptcy proceeding		Non-acceleration principle stated in the law. In case of insolvency, cash flows are credited to escrow accounts and a special cover pool administrator is appointed, who cancel the cover pool and the bond to a new institution.	In case of an issuer's bankruptcy, the cover pool shall not be subject to such issuers' bankruptcy proceeding, including compulsory execution, preservative measure and stay order. If the principal of the covered bonds is not fully paid, covered bond holders shall have the right to payment from other assets of the issuer
Issuance limit	None	10% of credit portfolios	20% of the issuer's credit portfolio	8% of total assets

* Financial institution with equity capital >KWR100bn and a 10% BIS ratio with adequate risk management
Sources: official legal sources, national authorities web sites, World Bank reports

1.4 ECB POLICY TOOLKIT AND COVERED BOND SUPPLY

By Maureen Schuller, ING Bank

Covered bond primary markets have experienced veritable peaks and troughs in the past number of years. Following a year of record issuance in 2006, euro benchmark covered bond supply dropped to EUR 96 bn in 2008 as the credit crisis, and more specifically the aftermath of the Lehman Brothers bankruptcy, cautioned investors as to the risk of being "burned" by what were perceived to be toxic financial debt holdings. Top quality ratings or backing by high quality (mortgage) loans had, by then, with the lessons learned from the structured credit crisis (Collateralised Debt Obligations (CDOs), subprime Mortgage-Backed Securities (MBS) and other permutations), become less of "sure thing". And yet, the primary markets for covered bonds recovered impressively: in 2011 euro benchmark issuance levels exceeded the 2006 record, an achievement that unfortunately was not sustained. Supply fell to EUR 114 bn in 2012, and the lower issuance levels year-to-date compared to last year (by some EUR 20 bn) indicate euro benchmark supply will struggle to exceed the important EUR 100 bn level this year, let alone the market high water marks of prior years.

The purported reasons for the volatility in euro benchmark supply are numerous, varying from Basel 3 Liquidity Coverage Ratio (LCR) proposals to upcoming bail-in regimes, from developments in senior unsecured spreads, and the decline in eligible mortgage assets to the legitimacy of asset encumbrance concerns. However, none of these aforementioned factors has so significantly affected covered bond supply conditions in these past years as has the intervention of the European Central Bank (ECB) with its broad palette of policy measures. Firstly, to stabilise conditions in the wake of the credit crisis and, subsequently, to contain the impact of the sovereign debt crisis on the wider financial sector. These measures were not only crucial from a funding cost perspective, but also offered investors the assurance of a "backstop investor" and provided virtually unlimited refinancing resources to banks.

> Figure 1: Important milestones: ECB policy measures

Date	Measure
06 Sep 2012	Announcement programme technicalities OMT
02 Aug 2012	Sovereign purchase announcement
01 Mar 2012	Settlement LTRO2
22 Dec 2011	Settlement LTRO1
08 Dec 2011	Announcement ECB 3yr LTROs
11 Nov 2011	Start CBPP2
06 Oct 2011	Announcement CBPP2
14 May 2010	Start SMP
10 May 2010	Announcement SMP
09 Jul 2009	Start CBPP1
07 May 2009	Announcement CBPP1

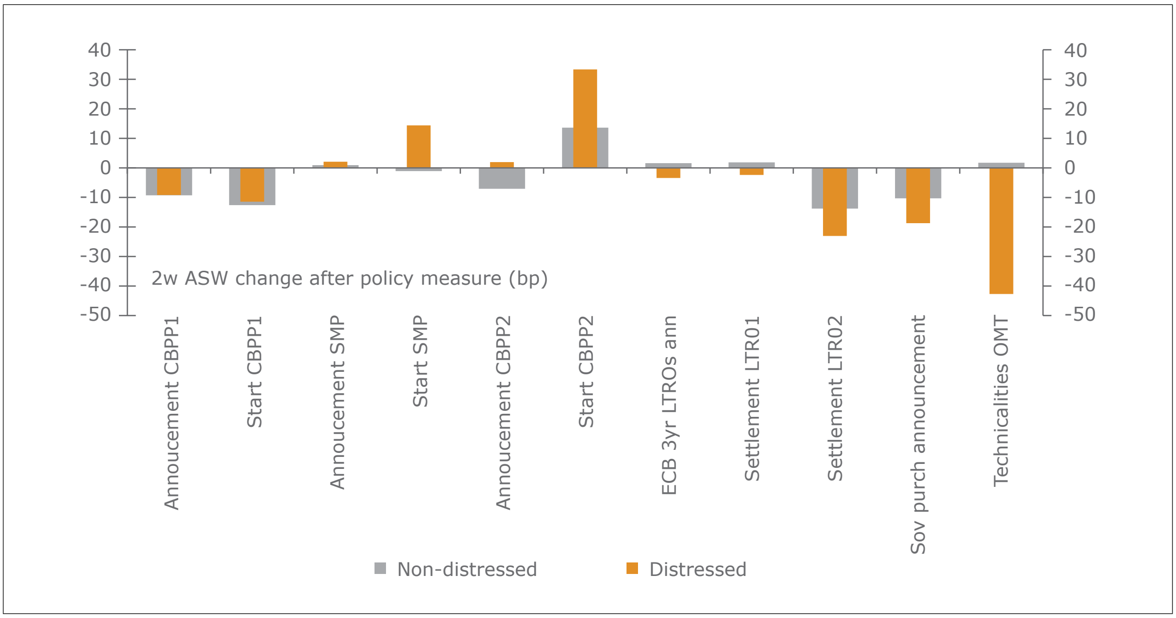
Source: ECB, ING

In this article, we discuss the impact of the ECB's policy measures on covered bond supply. Figure 1 offers a chronological overview of four of the most important ECB policy actions used to influence financial markets in general and / or covered bond markets in particular. These include the first window of the Covered Bond Purchase Programme (CBPP1) in 2009, the inception of the Securities Market Programme (SMP) in 2010, CBPP2, the first and second tranches of the 3 year jumbo Longer-Term Refinancing Operations (LTROs) and, most recently, the ECB's announcement of its willingness and capacity to conduct Outright Monetary Transactions (OMT). Note that the ECB had already started providing the European banking sector with unlimited allotments under its LTRO exercises in 2008 (not tabulated above), while in the past number of years, the ECB furthermore adjusted (read: expanded) on several occasions the eligibility criteria to ensure acceptance of a wider pool of collateral assets under its refinancing operations. Various amendments of the collateral eligibility criteria have either had direct or indirect implications for covered bonds. We will touch upon a few of them later in this article, but refer to the segment on the ECB collateral requirements in this Fact Book for a complete discussion of the ECB's collateral rules.

THE MOST EFFECTIVE ECB POLICY TOOLS

To optically demonstrate the "ECB effect" on funding cost developments, Figure 2 gives an overview of the change in distressed European countries (i.e. sourced from Spain, Italy, Ireland and Portugal) and non-distressed Eurozone covered bond ***spreads*** in the two weeks immediately following the announcement or commencement of the central bank policy measures as tabulated in Figure 1[1]. Figure 3 plots the euro benchmark and euro retained covered bond ***supply*** aggregates within the distressed (this time expanded to include Greece and Cyprus) and core European countries in the four weeks following each of the respective policy announcements. The figures suggest that of all ECB policy tools, CBPP1 and the OMT announcement have been most effective, not only in terms of reducing spreads, but also by facilitating renewed access for banks to (covered bond) primary markets.

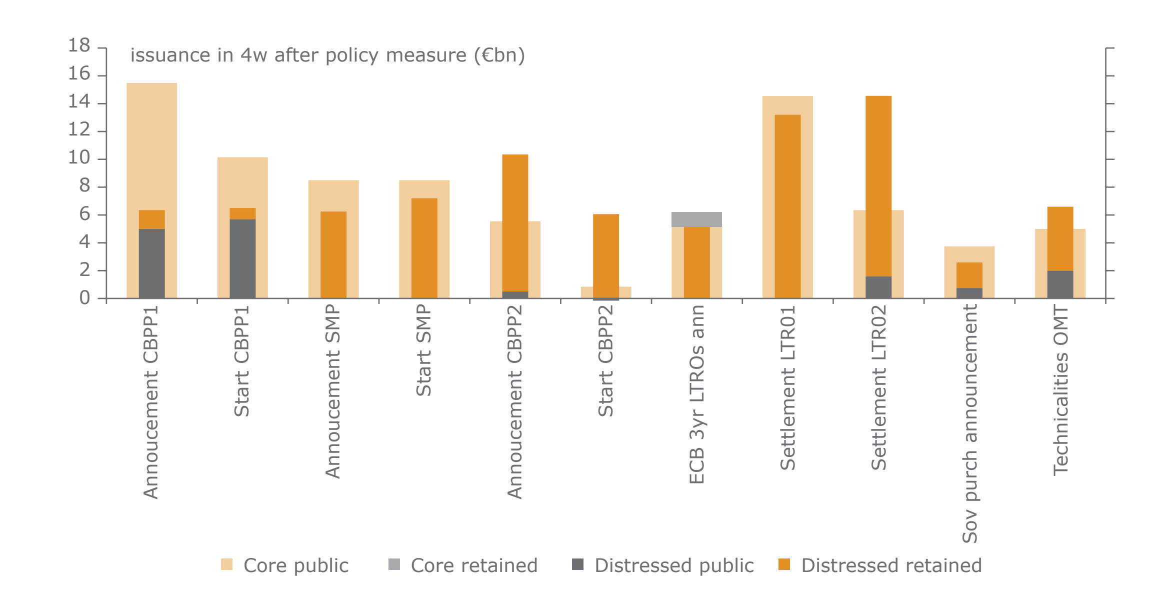
> FIGURE 2: IMPACT OF ECB MEASURES ON COVERED SPREADS



Source: ING

1 The numbers on spread and supply developments used for the purpose of this article are derived from our own database unless indicated differently

> Figure 3: Impact of ECB measures on covered supply



Source: ING

TRAVERSING THE POLICY TERRAIN

In the first half of 2009, the announcement by the ECB of **CBPP1** resulted in the reopening of covered bond primary markets following the credit crisis. Prior to the announcement, covered bonds across all jurisdictions continued to trade at stubbornly wide levels, while in contrast a tightening in senior unsecured spreads had already been witnessed. As a result of the mere indication of willingness by the ECB to purchase covered bonds, we saw a strong tightening in covered bond spreads. Figure 2 shows that in the two weeks after the announcement of CBPP1, spreads tightened by around 10bp. In the two weeks after the ECB actually started purchasing covered bonds under its first programme, spreads narrowed at least by a further 10bp. In terms of immediate covered bond supply response CBPP1 has clearly been more effective than any other enacted ECB policy measure (and in our view, subsequent initiatives declined in potency until the declaration by the bank that it would conduct OMT, which, of course, reset the game). In the month after the announcement of CBPP1, EUR 15 bn in core-European benchmark covered bonds were brought to the market and EUR 5 bn in distressed-European-sourced transactions. Another EUR 16 bn core/distressed euro benchmark debt was issued subsequent to the programme commencement.

The second covered bond purchase programme (**CBPP2**) announced in September 2011 did not have anything like its predecessor's impact on spreads. Together with the **Securities Market Programme (SMP)**, which was initiated in 2010 to alleviate pressure on the distressed sovereign bond market, it was probably one of the least effective ECB policy measures in recent years. Towards the end of 2011, the spread environment marked a sharp division between core Europe and the distressed European countries. In order to reduce funding costs and enhance liquidity in the covered bond market, the ECB in this instalment, had to tackle more complex sovereign risk, rather than "sector specific" banking concerns, as was the case in 2009. Banks domiciled in distressed European jurisdictions needed a tighter covered bond spread context, while in core Europe covered bond funding costs as well as liquidity were already in decent shape. In the two weeks subsequent to the announcement only non-distressed European covered bonds tightened (and then only marginally).

Both distressed and non-distressed covered bond spreads remained subject to widening pressure after the ECB actually started to purchase covered bonds under CBPP2. Primary markets continued to reflect the sharp geographic distinction between distressed and core European markets, with retained covered bond supply from distressed jurisdictions for central bank refinancing purposes remaining elevated in the months after the initiation of both the SMP in 2010 and CBPP2 in 2011, after which virtually no public deal from the distressed European countries was registered.

Towards the end of 2011, the European sovereign debt crisis had developed to a point where refinancing challenges for European banks started to spread beyond the contained distressed countries. As US money market funds backed away from European bank exposure, the ECB, in cooperation with the Bank of Canada, Bank of England, the Federal Reserve and the Swiss National Bank announced on 30 November 2011 inception of, among other things, temporary liquidity swap arrangements to augment the already extant US dollar liquidity swap facility, so as to further ease the pressure on European bank funding in foreign currency markets. However refinancing concerns did not really ease until the ECB announced on 8 December 2011 intentions to conduct two discrete Longer-Term Refinancing Operations (LTROs) each with a 3 year maturity.

The euro benchmark covered bond market did see a good number of deals subsequent to the announcement and settlement of **LTRO1**, despite the fact that an impact on covered bond spreads did not materialize until the run-up to and aftermath of **LTRO2**. However, public issuance from the distressed European banking sector still remained subdued. The period surrounding the LTROs was mainly characterized by a substantial increase in retained issuance in distressed jurisdictions, with distressed European banks using the covered bonds as collateral to attract cheap ECB funding, either to refinance maturing debt or to set up rewarding carry trades vis-à-vis own sovereign or home country covered bonds. Also, the LTROs did not have a real impact on covered bond spreads until the middle of January, i.e. when investors became more comfortable about the diminished refinancing risks for European banks and the liquidity procured under the LTROs was put to work. Therefore, the second LTRO had a much stronger impact on covered bond spreads than the first exercise. Distressed European covered bond spreads tightened by 22bp following the settlement of the second LTRO, while non-distressed spreads tightened by 10bp.

The effect of the joint LTRO liquidity window was temporary. After Q1 2012 spreads started to widen again and supply activity fell until ECB President Mario Draghi indicated at the end of July 2012 that the bank would do everything in its power to preserve the Euro. The ECB subsequently announced the OMT programme.

None of the ECB policy measures have had as much impact on distressed covered bond spreads as the announcement of the ECB to start purchasing sovereign bonds in the secondary market via OMT, subject to the significant caveat that an appropriate European Financial Stability Fund (EFSF) / European Stability Mechanism (ESM) programme is in place. The OMT superseded the SMP. The programme announcement immediately precipitated a 20bp tightening in distressed covered bond spreads on the back of the subsequent tightening in sovereign bond spreads of distressed countries, particularly for Spain. However, the strongest impact (i.e. a tightening of more than 40bp) was seen after the ECB announced the programme specifics and technical features of the OMT at the beginning of September 2012. While few covered bond issuers domiciled in distressed countries had already regained access to the primary market in the immediate aftermath of the OMT announcement, the second round effects (i.e. after a more pronounced decline in funding costs took place) were far more prominent.

THE ECB LTROS AND THEIR IMPACT ON SUPPLY

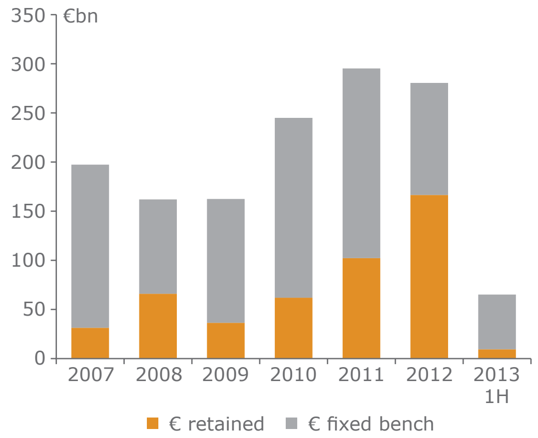
Although the OMT had the most significant impact on bank funding costs, the 3 year LTROs dramatically and permanently changed the covered bond funding landscape. They can, for a significant part, be held responsible for last year's *drop* in public covered bond issuance as well as for this year's subdued supply conditions.

The LTROs have essentially led to a replacement of public issuance with retained covered bond supply, first of all due to the fact that LTRO drawings replaced wholesale funding and, secondly, because the collateral pledged for retained covered bond debt left a lower eligible collateral stock available for the purpose of public issuance.

Figure 4 confirms that, although euro benchmark issuance has declined significantly, the total amount in euro covered bond debt printed remained relatively unchanged year-on-year. The more obvious impact on covered bond supply has been felt this year, with virtually no retained deals printed year-to-date and euro benchmark issuance lagging behind last year to the tune of EUR 20 bn, despite the higher redemption payments due this year compared to last year.

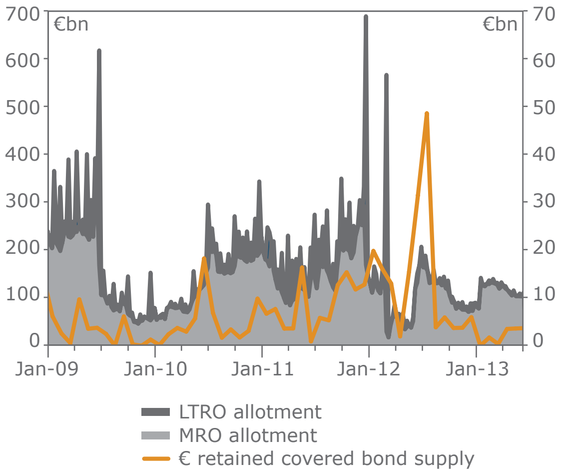
Figure 5 plots the rise in retained covered bond issuance in the run up to the two 3 year LTROs and sharp decline after last year's July peak. On 8 December 2011, when the ECB announced its 3 year LTROs, it provided counterparties also the opportunity to shift all of the outstanding amounts of the October 2011 12 month LTRO into LTRO1. This 12 month LTRO already coincided with a significant increase in retained covered bonds printed. The amount of retained debt printed fell again after LTRO2, to reflect an absolute peak in the summer of 2012. Here, some banks opted to generate further eligible collateral in anticipation of a persistent weakening of market conditions.

> Figure 4: Retained issuance replaces public issuance



Source: ING

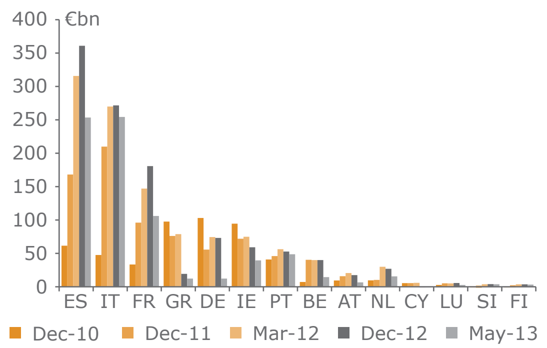
> Figure 5: Retained covered bond issuance increases



Source: ECB, ING

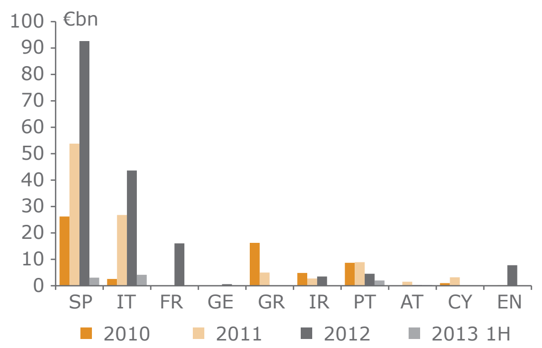
The 3 year LTROs of EUR 489 bn and EUR 530 bn have led to an increase of EUR 321 bn and EUR 304 bn respectively in the total amount outstanding under the ECB's LTRO programme given that part of the borrowings under these two facilities replaced previous shorter term LTRO borrowings. The increase in overall ECB borrowings was EUR 335 bn and EUR 145 bn respectively as borrowings under the Main Refinancing Operations (MRO) reduced in parallel. Almost EUR 50 bn in retained covered bonds was issued in this period to attract funding under the LTRO facility. In particular Spanish and Italian banks have heavily used the LTROs (see Figure 6), which coincided with a sharp rise in retained issuance in 2011 and 2012 in these jurisdictions (Figure 7). The traditional retainers (i.e. Greece, Cyprus and Ireland) have seen their retained covered bond supply decline compared to 2010.

> FIGURE 6: ECB REFINANCING DRAWINGS BY COUNTRY



Source: NCBs, ING

> FIGURE 7: RETAINED EURO COVERED BOND ISSUANCE BY COUNTRY

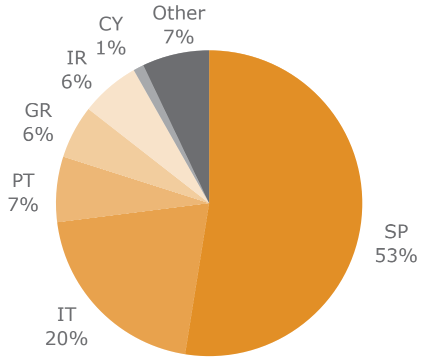


Source: ING

Figure 8 gives an overview of the percentage of retained covered bond issuance per country referencing the period from 2009 until the first half of this year. The chart shows that Spanish issuers take the lion's share with more than half the retained covered bond debt issued in this period. Spanish issuers have as such relied more on covered bonds for ECB collateral purposes than the Italian banks. Almost half (49%) of the increase in ECB borrowings by Spanish issuers from December 2010 to December 2012 was collateralised with retained covered bonds. For Italian issuers approximately one third (31%) of the rise in borrowings from the ECB was backed by retained covered bond collateral.

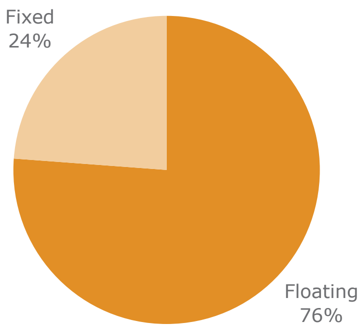
Most of the retained issuance has been in floating coupon format, to benefit from a more favourable haircut (0-1yr maturity bucket) for ECB collateral purposes (Figure 9).

> FIGURE 8: RETAINED EURO COVERED BOND ISSUANCE BY COUNTRY



Source: ING

> FIGURE 9: RETAINED FIXED VERSUS FLOATING COUPON ISSUANCE

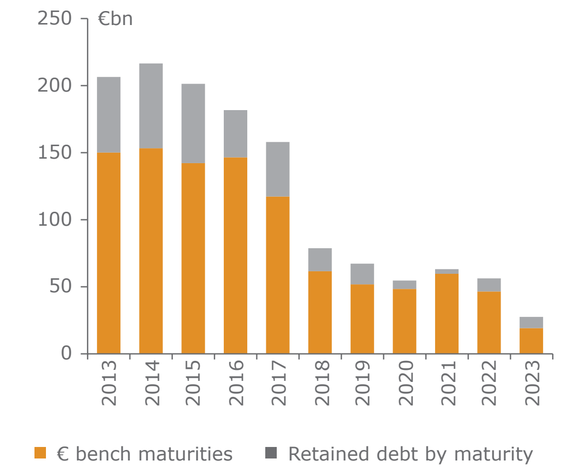


Source: ING

THE 2015 REFINANCING SPIKE

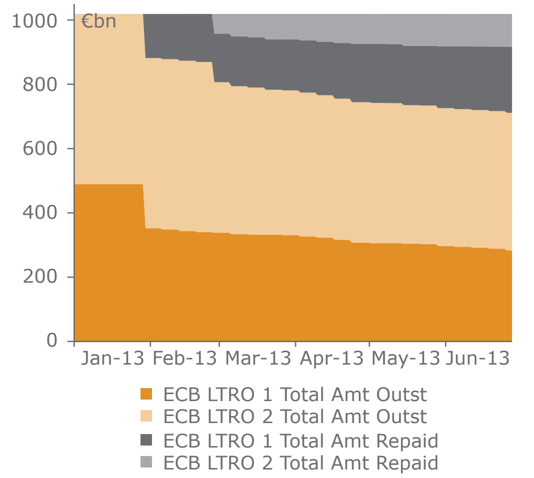
In line with the maturity of the two 3 year LTROs in January and February 2015, most of the retained covered bond debt currently still outstanding matures in 2014 and 2015, underscoring the refinancing pressure financial institutions will face in the coming years, not only in terms of underlying bond debt redeeming but also with the two jumbo 3 year LTRO facilities expiring in early 2015.

> Figure 10: Euro bench and retained debt maturities



Source: ING

> Figure 11: LTRO debt outstanding and amortized



Source: ECB, Bloomberg, ING

Until the end of June 2013, European banks had already repaid EUR 307 bn of the almost EUR 1,020 bn in LTRO debt on their books (Figure 11), which has coincided with an early amortization of EUR 58 bn in retained covered bond debt. After a decent chunk of debt being repaid at the first possible redemption opportunity, the pace of repayment has slowed up. If banks continue to repay LTRO debt at the current pace, there is still EUR 155 bn in debt outstanding at the 2015 due date to be rolled over via shorter-term ECB borrowing avenues, or to be refinanced otherwise.

> Figure 12: The three jumbo LTRO take-ups

	Tender date	Maturity date	Allotted amt (€ bn)	Outstanding 30 June 2013	Cum. repaymt 30 June 2013	Take-up No. of banks	No. of banks repaying 30 June 2013
3 year LTRO II	29 Feb 2012	26 Feb 2015	529.5	427.8	101.7	800	559
3 year LTRO I	21 Dec 2011	29 Jan 2015	489.2	283.4	205.7	523	446
1 year LTRO	24 Jun 2009	01 Jul 2010	442.2			1,121	

Source: ECB, Bloomberg, ING

Although part of the refinancing need will ameliorate given balance sheet de-leveraging, improvement in stable private funding sources (deposits) or senior unsecured funding, it is fair to assume that the expiration of the LTROs and (pre)funding of LTRO repayments will provide positive momentum to covered bond supply in the coming two years. Even despite negative trends such as housing market declines, rising non-performing loans or asset encumbrance restrictions limiting the availability of eligible collateral for covered bond issuance purposes, redemptions of around EUR 150bn in retained covered bond debt until the end of 2015 have the potential of releasing a substantial amount of eligible assets for public issuance, if indeed not rolled over into fresh retained covered bond supply for ECB funding purposes (Figure 11).

NARROWING THE SCOPE FOR COVERED BOND ELIGIBILITY

The odds are high, however, that the trend of abundantly available central bank funding will be reduced. After having softened its collateral eligibility criteria at various points over the past few years, the ECB has, as far as the covered bond market is concerned, already toughened up on collateral acceptance in recent months for instance.

On 28 November 2012, the central bank amended the "close-link" provisions for the use of "own" covered bonds as collateral. As from the beginning of this year, retained covered bonds can only be used as collateral if they are UCITS 52(4) compliant and meet the Capital Requirements Directive requirements (points 68 to 70 of Annex VI to Directive 2006/48/EC) with respect to eligible assets. Covered bond instruments backed by similar safeguards can only be used if they fulfil all the aforementioned UCITS 52(4)/CRD requirements with the exception of the limits on guaranteed loans in the pool, which permits the eligibility of French Obligations de Financement de l'Habitat (OFH). Previously all UCITS 52(4) compliant covered bonds were eligible, even if they did not meet the CRD specific asset requirements. This included, for example, German covered bonds backed by aircraft loans. Also non UCITS-compliant structured covered bonds were eligible if they met the criteria laid down in the ECB's general documentation.

Furthermore, as of the beginning of April this year, the ECB will only accept covered bonds that contain asset-backed securities in the pool, if these covered bonds are CRD compliant and if the securitization notes backing covered bonds were originated by an entity that is a member of, or affiliated to, the same consolidated group of which the issuer of the covered bond instruments is also a member or affiliated. This amendment only affects four French covered bond issuers with collateral pools that are (partly) backed by securitization notes, of which three did not fulfil the new requirements. Covered bonds that were on the list of eligible asset-backed securities until 28 November 2012, but do not comply with the new collateral requirements, will furthermore remain eligible as collateral until 28 November 2014. New issuance after November 2012 is immediately affected however.

Under the ECB's amended collateral rules, the acceptance of unrated UCITS-compliant covered bonds issued prior to 1 January 2008 has also been phased out. Although these three measures do narrow the scope of eligible covered bond collateral, they only negligibly affect the retained euro covered bond landscape as it is today.

However, on 22 March 2013, the ECB adopted yet another collateral decision potentially affecting covered bonds. As of 1 March 2015, i.e. after the maturity date of the 3 year LTROs, uncovered government-guaranteed bank bonds, that have been issued by the counterparty itself or an entity closely linked to that counterparty, can no longer be used as collateral for ECB refinancing purposes. According to Dealogic data EUR 54.3 bn in retained government-guaranteed debt matures after 28 February 2015, of which EUR 41 bn is Spanish. This could prompt issuers that would still be reliant on ECB funding to use covered bonds instead of government-guaranteed debt issuance as collateral.

As of 28 February 2015, the Eurosystem will also **no longer accept retained covered bonds** backed by own uncovered government-guaranteed bank debt instruments. This measure is also not expected to have a significant impact on the retained covered bond segment, as the use of retained public sector covered bond debt has been less frequent to begin with considering that the public sector collateral backing a covered bond could often be used directly as collateral with the ECB on more favourable terms vis-à-vis haircuts etc. Of the roughly EUR 320 bn in retained covered bond debt still outstanding, only 10% is public sector covered bond debt of which 65% was issued by Spanish credits.

On 18 July 2013, the ECB decided to further discourage the use of retained covered bonds for central bank collateral purposes by introducing additional valuation markdowns of 8% for A- or better rated retained covered bonds, and 12% for retained covered bonds rated BBB+ to BBB-.

CONCLUSION

The ECB has, with a variety of policy measures, left an indelible stamp on euro benchmark covered bond supply conditions over the past couple of years. While the OMT has been the most effective tool in terms of reducing (covered bond) funding costs, the two 3 year LTROs have permanently re-contoured the covered bond funding landscape. They are probably the most important explanation for last year's decline in euro benchmark supply and can also be held accountable for this year's subdued public covered bond issuance. However, with the 2015 maturity date approaching and almost EUR 150 bn in retained covered bond debt rolling off the curve towards the end of 2015, public covered bond issuance can be expected to receive positive impulse. Momentum that could well be enhanced by the ECB's increasingly more proscribed stance on the acceptance of (retained) covered bond debt for collateral purposes.

1.5 COVERED BONDS VS. SOVEREIGN DEBT

By Florian Eichert, Crédit Agricole CIB and Franz Rudolf, UniCredit

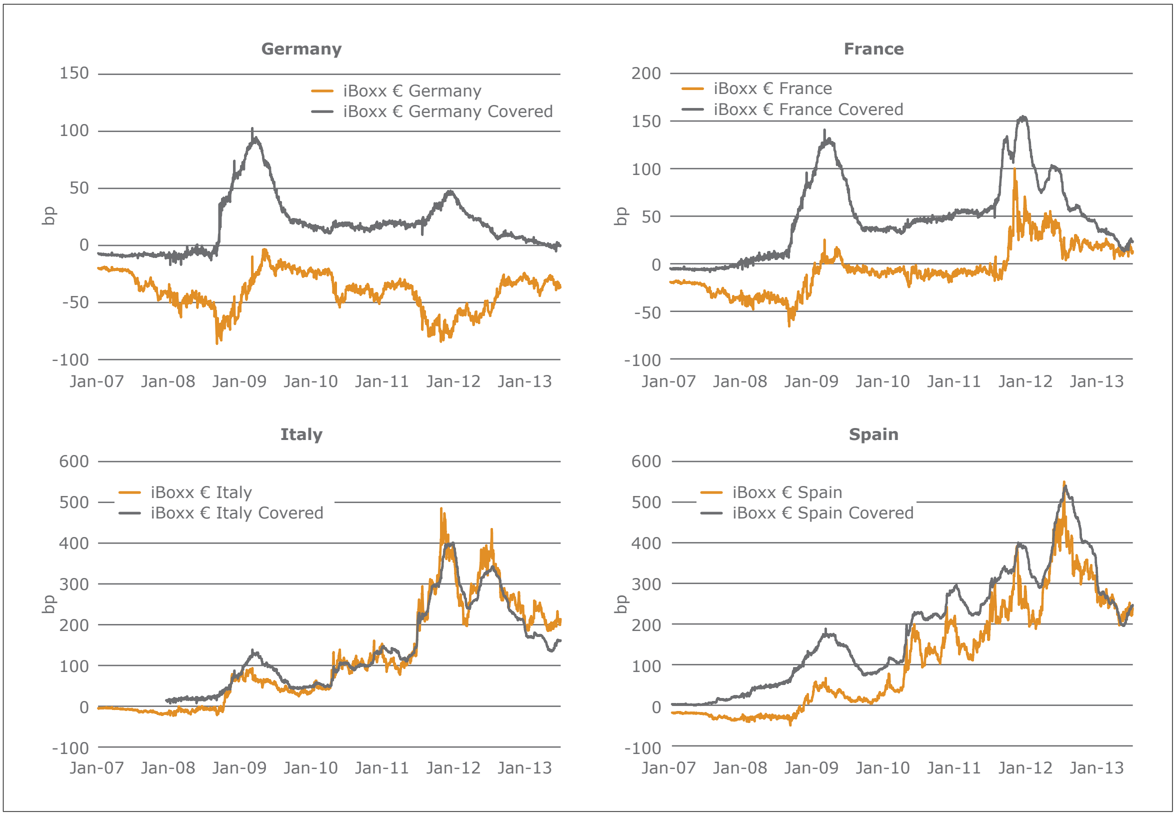
INTRODUCTION

Can covered bonds trade tighter than their respective sovereign? Yes, indeed! Does it make sense? There are good reasons for it, but it depends. So the question is, "What is the rationale behind it"? In this article, we examine the current situation, look at the relationship between covered bonds and sovereign spreads, evaluate the drivers behind this development, and show the reaction of investors to it.

The structural aspect of bond spreads has always been taken as a given: sovereign spreads trade the tightest, then come sub-sovereigns and agencies, and then covered bonds, followed by senior unsecured with quite a gap. However, with the financial crisis and the subsequent sovereign debt crisis, this pattern was not any longer true for all covered bond markets. Instead of trading with a significant pick-up compared to the respective sovereign, covered bonds in peripheral countries like Spain, Portugal, Ireland or Italy started to trade at the same level or even noticeably tighter – depending on the respective country and especially depending on the specific issuer.

The charts below show the development of covered bonds and their sovereign on an index level (iBoxx). This can only give a first and rough indication of the actual picture due to the fact that index compositions change over time and duration also differs across the two indices – besides name differentiation among covered bond index constituents.

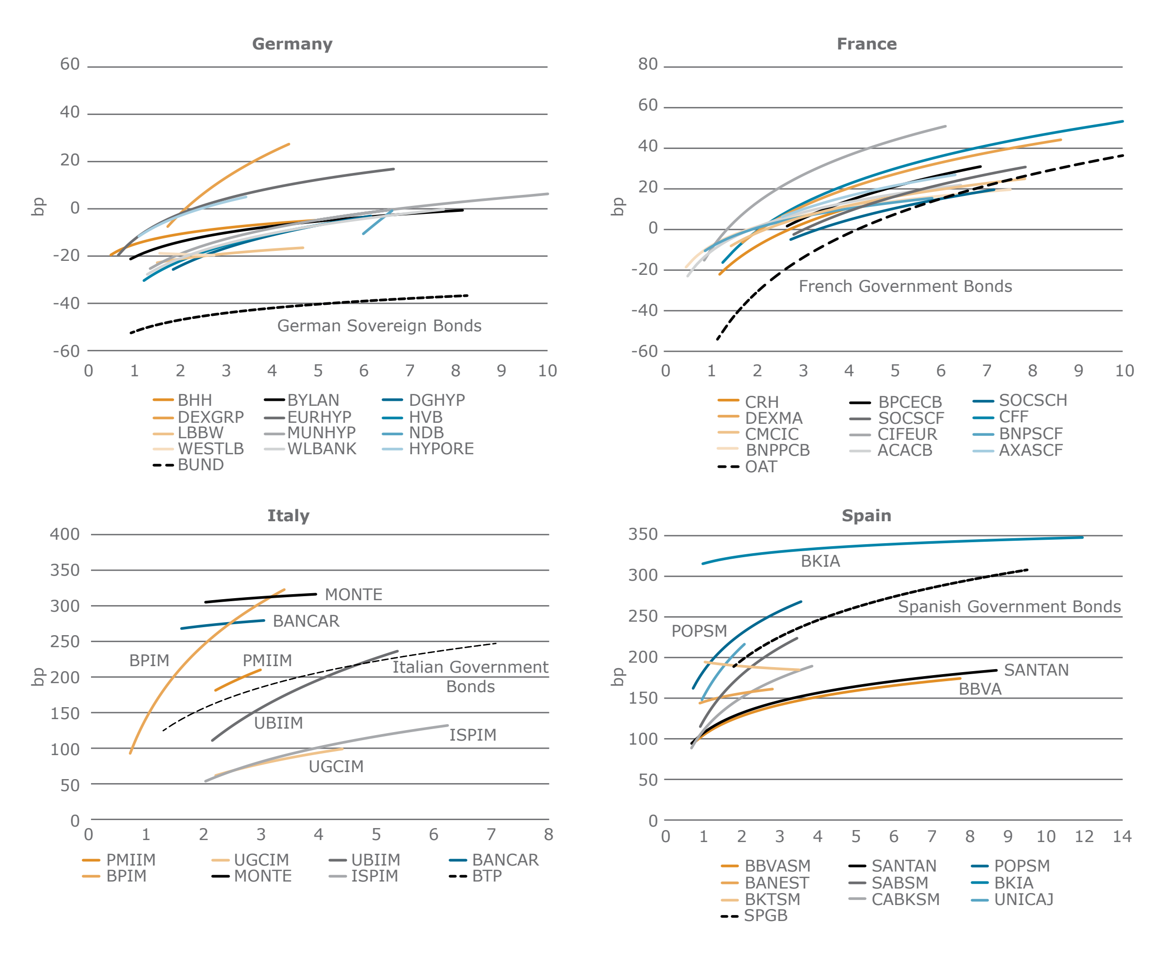
> FIGURE1: COVERED BONDS VS. DOMESTIC SOVEREIGN



Source: UniCredit Research

When looking in more detail at the respective covered bond markets, it shows that name differentiation plays a key role. This becomes especially important in peripheral countries, where usually first and in some cases also second tier issuers trade inside their respective sovereign curve, while lower tiered issuers still show a pick-up versus their sovereign. Although it could be argued that the first tier segment typically relates to large banking groups, which might be internationally more diversified and thus do not solely reflect domestic exposure, the underlying mortgage cover pools are, with only a few exceptions, exposed solely to domestic (residential) mortgage loans. Thus, in the case of the issuer's default, this cover pool constitutes the relevant collateral for claims. A differentiation can also be made when talking about system relevant banks and non-systemic relevant banks. As we show in this article, this might become an important topic when it comes to the scenario that, while a sovereign might get into trouble, system relevant banks are still saved (e.g. by the European Union) in order to maintain a basic level of financial services in that country.

> FIGURE 2: STRONG NAME DIFFERENTIATION AMONG COVERED BONDS



Source: UniCredit Research

ARE COVERED BONDS COMPLETELY DELINKED FROM SOVEREIGN RISK?

In case selective covered bonds trade significantly tighter than their respective sovereign, these covered bonds are apparently perceived as more attractive or more "safe" (or, in other words, they have a lower expected loss given default) than sovereign bonds. While we will examine the reasoning backing this argumentation later on, we also want to highlight the relevant links between the performance of sovereign bonds and covered bonds. In the following argumentation, we refer to covered bonds with purely domestic collateral in the mortgage segment, as is the case for most mortgage cover pools outside Germany.

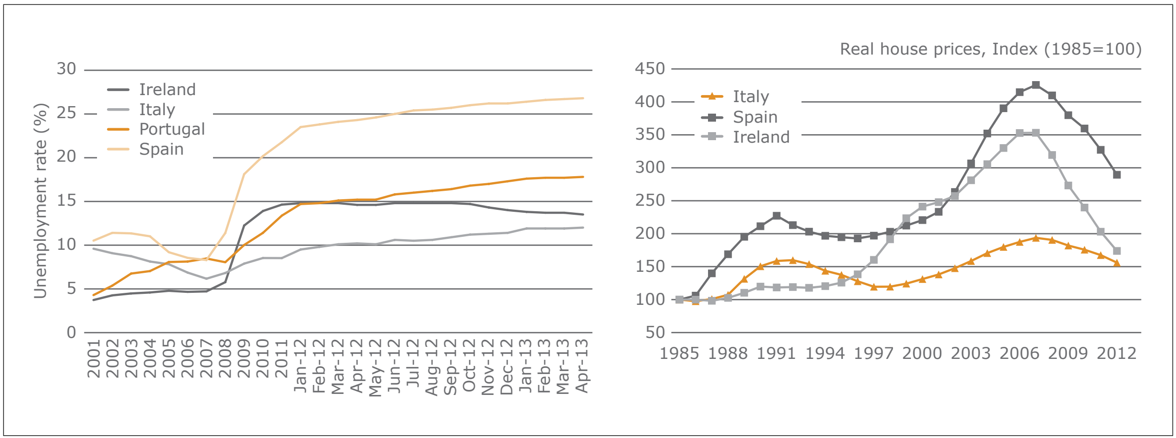
In a scenario when a sovereign defaults or gets close to default, be it due to extremely high debt levels and/or the collapse of selective industry sectors, the effects on the economy are extremely detrimental, implying high unemployment rates. Increasing unemployment rates, however, are accompanied by declining house prices. House prices strongly fall as demand for buying or building new homes dries up. Together with increasing mortgage loan default rates – an increasing number of people are not able to make the monthly instalment payments due to a lack of income – the number of real estate foreclosures surges, meeting low demand and adding to the house price decline. The vicious circle is in full swing. With declining house prices, loan-to-value (LTV) ratios go up – the outstanding mortgage loan volume remains unchanged while values decline. What effect does that have on mortgage cover pools? Banks would be pressured to add additional collateral, which gets increasingly difficult. Either banks have also defaulted, or at least some of them that are not considered as system relevant (1) and were not rescued by the, e.g., European Union, or they are kept alive but suffer from increasing non-performing loans (2). In the first case, the cover pool has been segregated and turned static. Thus, additional collateral to compensate for increasing LTVs is not available and the covered bond investor has to rely on the overcollateralization in the pool. In the second case, adding additional high quality collateral becomes increasingly difficult as new business ceases. In either case, the effects for covered bondholders are negative.

Going one step further, i.e. if the sale of the portfolio becomes necessary, for example as liquidity is needed in order to pay back a maturing covered bond in a post-insolvency scenario of an issuer, the number of potential buyers becomes very limited in a stressed environment and the amount a buyer would be willing to pay for mortgage loans also declines strongly. This is also reflected in the methodology of rating agencies to model refinancing risks. Rating agencies have increased the calculated refinancing margins in recent years in order to adequately address this risk. Depending on the level of overcollateralization in the cover pool, among other factors, the achieved amount will be sufficient or not to cover the claims. In a last consequence, the sovereign might event be tempted to change an existing legal framework. An example in 2011 was Hungary, when Parliament passed a law allowing mortgage borrowers having mortgage loans in a foreign currency to repay their loans at exchange rates around 25% below market rates with losses to be borne by the lending banks. A more recent example is the attempt of Spanish regions like Andalucia to stop evictions of mortgagers in order to allow them to stay in properties where they have defaulted on. Mortgagees (Spanish banks) would be expropriated for a period of three years, in which they would not be authorized to access, use or dispose of the properties. In addition, banks not offering vacant properties for rent would have to pay a fine of EUR 9,000 per property. The effects on covered bonds in this example would be negative, especially in a post-insolvency scenario of an issuer as it threatens the basis of covered bonds, the collateral, and would trigger further implications on recoveries and thus also on ratings.

In the scenario illustrated above, the deteriorating rating of issuers and hedging counterparts becomes an additional negative factor. Following the inevitable rating downgrade of the sovereign when defaulting, the ratings of the banks are also lowered, pressuring the ratings of the respective covered bonds. While we do not want to get into too much detail regarding rating methodologies (sovereign rating caps, timely payment indicator, discontinuity cap, committed overcollateralization, etc.), the negative consequence on covered bond ratings is system immanent. As these effects are not limited to a single name, i.e. an isolated issuer, in the case of a sovereign stress scenario, also hedging counterparties from the same country will be affected. As in many cases hedging instruments are linked to certain rating triggers of the hedging counterpart, it might be necessary to replace a hedging counterpart in an environment with systemic impact.

The above shows that covered bonds cannot be viewed as delinked from a sovereign facing severe hardship. However, there are also arguments that mitigate this linkage and provide the rationale for covered bonds to trade inside the respective sovereign.

> FIGURE 3: UNEMPLOYMENT RATES AND HOUSE PRICES IN PERIPHERAL COUNTRIES



Source: OECD, national sources, UniCredit Research

RATIONALE FOR COVERED BONDS TO BE INSIDE

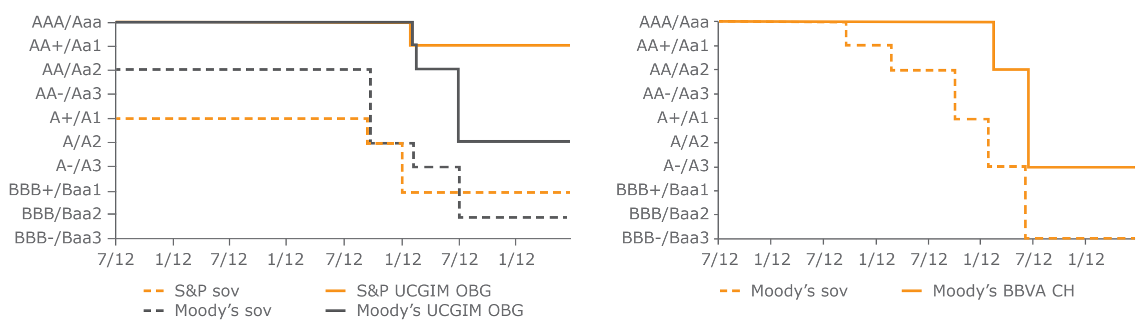
Sovereign risk is playing too big of a factor in covered bond structures to just ignore it. Nonetheless, there are reasons why in some cases covered bonds could and even should trade inside their respective sovereign bond curves.

Rating stability

Thanks to the overall shift downwards of both sovereigns, issuers as well as, to a lesser extent, covered bond ratings, investors had to adjust to a new situation. Whereas having and maintaining an AAA was crucial in the past for covered bonds, it is usually no longer the case as the focus has shifted south. Nonetheless, we have reached levels in some countries by now where ratings do start to matter again, as it does make a difference whether they are BBB- or BB+. Especially in cases where sovereign ratings have been under a lot of pressure, covered bonds have been able to play their full strength. S&P's OBG ratings of Italian national champions, for example, are still rated 6 notches above the Italian sovereign, while Moody's grants three notches of uplift. In addition, the OBG ratings have been much more stable historically than the Italian sovereign.

In Spain, the sovereign is rated Baa3 outlook negative by Moody's, while the Cedulas of at least the better issuers are still A3 and thus three notches away from dropping to non-investment grade. Investors who are prohibited from holding non-investment grade debt are therefore eying covered bonds as a way of keeping exposure to Spain, even if Spain should be downgraded. Deeply negative spreads to the Spanish sovereign don't necessarily keep those investors from buying Cedulas, as the sovereign would not be an investable alternative anymore should the downgrade eventually happen.

> FIGURE 4: COVERED BOND VS. SOVEREIGN BOND RATINGS



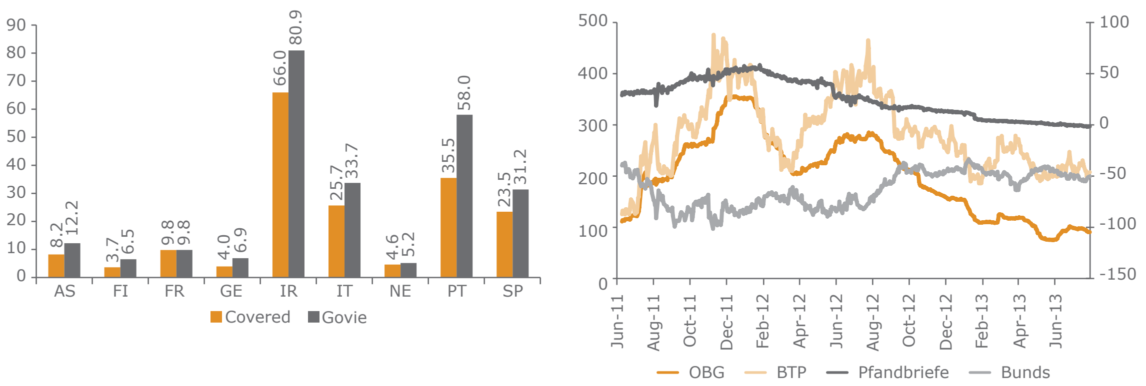
Sources: Bloomberg, Crédit Agricole CIB

Spread stability

Covered bond spreads have held up remarkably well when compared to sovereign debt despite the recent months' spread volatility. They have been much slower to react when markets were widening and the ultimate widening was less pronounced than that in the sovereign universe. The downside to this has been that, in tightening periods, they were lagging as well.

When looking at rolling 90D standard deviations of 5Y covered bond as well as sovereign spreads, covered bonds showed the lower volatility in all markets in the sample.

> FIGURE 5: ROLLING 90-DAY STANDARD DEVIATION ASSET SWAP SPREADS 5Y COVERED AND SOVEREIGN BONDS 2010 - 2013



Sources: Bloomberg, Crédit Agricole CIB

One of the reasons for this lagging of covered bonds is certainly the different investor base and less active trading in covered bonds. Buy and hold investors play a much more important role in covered bonds, whereas trading accounts are more active in sovereign debt.

Spread volatility is less of a problem for long-term buy and hold investors, but certainly causes problems for asset managers valuing their funds' assets on a daily basis. It also causes problems for banks VAR calculations. While European banks don't have to hold capital for European sovereign debt, they do have to hold capital to cover the volatility of their trading assets. And the more volatile a certain asset is, the more capital banks have to hold. Spread stability of covered bonds has thus a very feasible economic value and reduces the overall capital consumption difference to sovereign debt.

ECB repo efficiency

Bank investors are a major investor base in both sovereign as well as covered bonds. One of the main things bank treasuries focus on when investing is the repo efficiency of an investment. The lower the haircuts and the less volatile prices, the better.

Repo haircuts for covered bonds are fairly similar with those of sovereign debt as long as both are rated at least A- by one rating agency (the best rating is relevant for this purpose). Currently, most covered bonds in the market fall into the lower haircut table, even if in some cases they only benefit from this thanks to their additional DBRS rating. The haircut for a 4Y jumbo covered bond is 2.5%, while the equivalent sovereign bond has a haircut of 1.5%. In case of below EUR 1 bn benchmark covered bonds, the haircut is slightly higher at 3.0%, but this doesn't materially change the outcome of our comparison.

> Figure 6: Eurosystem repo haircuts

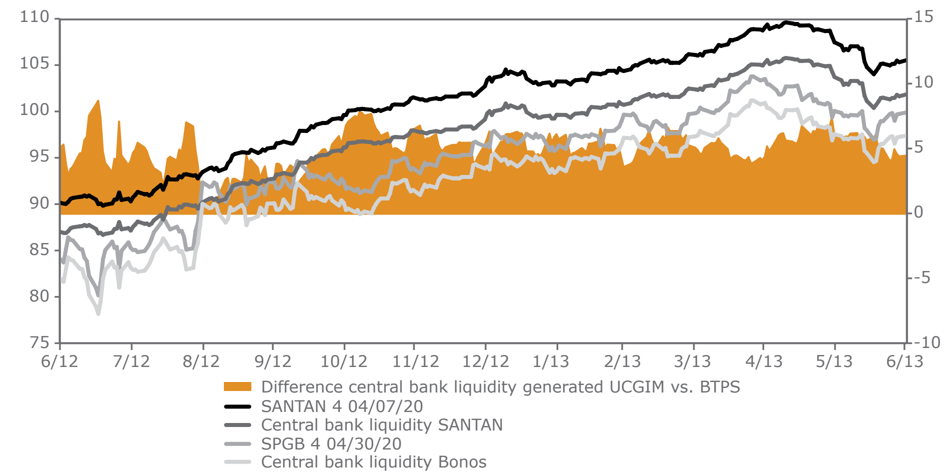
AAA to A-	**Liquidity Categories**								
	I Government Bonds		**II** Local & Regional Govt, Supras & Agencies, Jumbo Covered Bonds		**III** Traditional Covered Bonds, Structured Covered Bonds, Multi-Issuer Covered Bonds, Corporates Bonds		**IV** Unsecured Bank Bonds		**V** ABS
Residual maturity (years)	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed or zero coupon
0-1	0.5	0.5	1.0	1.0	1.0	1.0	6.5	6.5	10.0
1-3	1.0	2.0	1.5	2.5	2.0	3.0	8.5	9.0	10.0
3-5	1.5	2.5	2.5	3.5	3.0	4.5	11.0	11.5	10.0
5-7	2.0	3.0	3.5	4.5	4.5	6.0	12.5	13.5	10.0
7-10	3.0	4.0	4.5	6.5	6.0	8.0	14.0	15.5	10.0
>10	5.0	7.0	8.0	10.5	9.0	13.0	17.0	22.5	10.0
BBB+ to BBB-									
Residual maturity (years)	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed or zero coupon
0-1	6.0	6.0	7.0	7.0	8.0	8.0	13.0	13.0	22.0
1-3	7.0	8.0	10.0	14.5	15.0	16.5	24.5	26.5	22.0
3-5	9.0	10.0	15.5	20.5	22.5	25.0	32.5	36.5	22.0
5-7	10.0	11.5	16.0	22.0	26.0	30.0	36.0	40.0	22.0
7-10	11.5	13.0	18.5	27.5	27.0	32.5	37.0	42.5	22.0
>10	13.0	16.0	22.5	33.0	27.5	35.0	37.5	44.0	22.0

Sources: Eurosystem, Crédit Agricole CIB

If we look at two bonds with identical coupons and similar maturities, the one with the significantly tighter spread is trading at the higher price and, thus, generating more central bank liquidity (liquidity is measured based on the market price minus haircut). When examining this comparison between sovereign bonds and covered bonds, sovereign debt is the clear winner in virtually all core countries thanks to slightly lower haircuts but most of all higher prices. In countries such as Belgium, even the additional liquidity from slightly negative covered-sovereign spreads is offset by the lower haircuts of Belgian government bonds.

However, in Spain for example, covered bonds beat their sovereign equivalent when it comes to ECB liquidity generated. The SANTAN 4 07/2020 Cedulas Hipotecarias is generating almost 6 points more cash from repo-ing it with the Eurosystem than the SPGB 4 03/2020. And what adds to the argument is the higher degree of price stability of the Cedulas. Not only is it generating more liquidity, it is generating the more stable liquidity.

> FIGURE 7: LIQUIDITY GENERATED FROM REPOING 7Y SANTANDER CEDULAS VS. 7Y BONOS



Sources: Bloomberg, Eurosystem, Crédit Agricole CIB

This rationale obviously only works for covered bonds that are already trading deeply inside sovereign debt as mentioned, and only in instances where coupons and maturities are comparable. It does not work for covered bonds in core sectors where sovereign debt is still the more ECB repo efficient tool in general. And even in the periphery, the situation is very rating dependent. Below A-, the pendulum swings back towards sovereigns even in countries such as Spain, as the repo haircut differences become bigger. Last but not least, one could argue that the liquidity argument is more a reaction to than a cause for negative covered-sovereign spreads.

Bottom line: repo efficiency is not something that would drive covered bonds deeply into negative spread territory relative to sovereign debt. But it is certainly a factor in stabilizing spreads once they get there, as it becomes a self-enforcing factor which weighs more, the deeper negative spreads are.

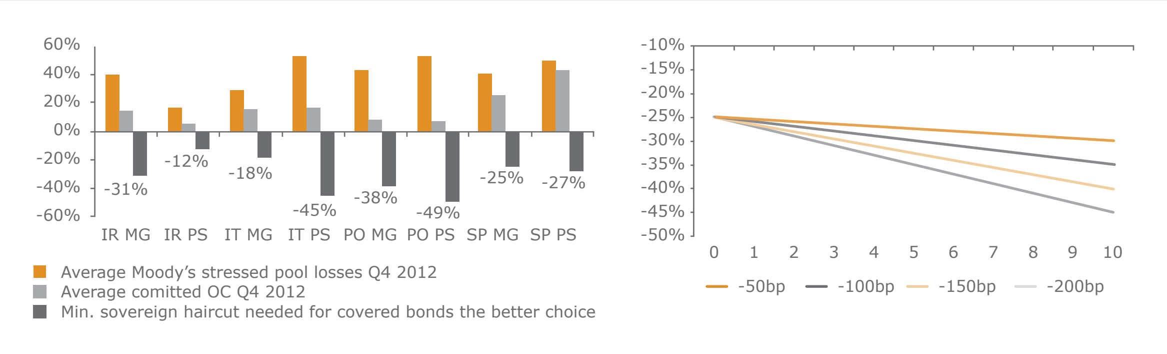
Tail risk – expected recoveries

One of the most powerful arguments an increasing number of investors use to defend negative covered-sovereign bond spreads is their expectation that tail risk in covered bonds is less than in sovereign debt. Especially long-term investors, such as insurance companies, have increasingly stated this view. They feel more comfortable with the collateralized claim than the sovereign debt.

When making this assessment, it is important however to go one step further, as the validity of this statement depends on the actual pool backing the covered bonds, the framework regulating it and, most importantly, the issuer itself. Chances that this view will prove right are much higher for high quality residential mortgage backed covered bonds from a country with a strong framework that are issued by a systemically important bank than lower quality public sector backed covered bonds issued by a small non-systemically important issuer. Another important aspect is that the stronger a sovereign is the less relevant are considerations about tail risks and recoveries, while they become much more important where sovereigns are in a difficult situation.

It is hard to estimate cover pool recoveries based on issuer reporting. Rating agencies, however, publish the results of their own cash flow modelling of pool and liabilities. Moody's stressed pool losses express their view on expected losses should a cover pool be wound down. One can use this number and apply it to a pool which is left with legal minimum OC to come up with an estimated recovery rate. For Spanish mortgage cover pools, for example, the estimated loss is in the region of 25%.

> Figure 8: Committed OC, Moody's stressed pool losses, and required sovereign haircut to be better off with covered bonds



Sources: Moody's, Crédit Agricole CIB

This number can be used to either estimate cash prices below which a purchase should result in a positive return, even if both the bank and the covered bonds default. It can however also be used as a proxy for the required haircut on a sovereign bond that would make the covered bond the better option. In the Spanish case, for example, if a sovereign haircut on Spain were to be in excess of 25%, the expected recovery on the Cedulas would be higher. If investors believe the haircut is lower, sovereign debt would be the better option.

Obviously, this calculation is subject to the yield to maturity an investor initially buys in the sovereign debt and covered bonds. The above-mentioned calculation assumes that both trade at the same yield. If one adds the negative covered-sovereign spread in Spain to the equation, for example in case of Cedulas levels 100 bps inside Bonos, the Bonos produces 100 bps extra carry p.a., which in effect means that the Bonos investor builds up an additional buffer or 1% p.a. and that this expected recovery moves by 1% to the disadvantage of covered bonds per year. In other words, the better recovery on covered bonds has its price and at some point, the balance shifts to the sovereign debt depending on the cover pool quality, strength of the bank and framework.

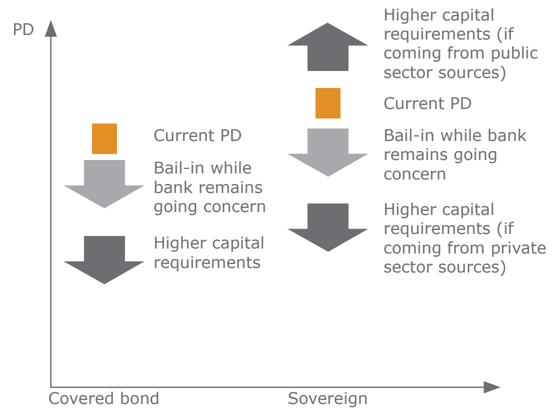
What this calculation also doesn't take into account is the probability that some banks could very well survive a sovereign debt restructuring (via capital support by the domestic sovereign or an European entity and liquidity support by the Eurosystem) and that, irrespective of potential recoveries, covered bonds could be the better choice. Sovereigns need to maintain a basic level of banking services in a country and would recapitalize at least some of the country's large retail banks immediately after the sovereign debt restructuring. National Bank of Greece is a good example for this.

Bail in

As opposed to the covered bonds vs. senior relationship, the impact of adding bail-ins and higher capital levels to the equation isn't as straight forward to the covered bonds vs. sovereign bonds comparison. Involving private sector investors in a bail-in which leads to the survival of the bank is both positive for covered bonds as well as for sovereigns (this obviously assumes that there are bail-in-able investors or depositors, it becomes less relevant when talking about specialized covered bond issuers that are predominantly covered bond funded). Spreads between the two products shouldn't really be driven by this additional element in these cases.

In case, however, where banks in question don't really have any external unsecured and subordinated investors but are predominantly retail deposit and central bank funded, adding bail-ins to the equation doesn't really mean additional relief for sovereigns. And if higher capital weights can only be implemented via support from the governments, their investments in the banking sector actually increase, driving up the sovereign debt load and, thus, risk. In these cases, adding bail-ins and higher capital requirements to the equation is actually positive for covered bond spreads relative to sovereign bonds.

> Figure 9: Impact of bail-ins and higher capital requirements on covered bonds' and sovereign bonds' risk



Sources: Crédit Agricole CIB

IMF comments

The IMF published a document called "Sovereign debt restructuring – recent developments and implications for the fund's legal and policy framework" this May. In it, the IMF reviews the recent sovereign debt crisis in which it was involved. One of the results of the review is a call for an earlier as well as more frequent involvement of private sector investors in sovereign debt restructurings. The IMF even discusses making private sector involvement a pre-condition for IMF involvement:

> "For example, a presumption could be established that some form of a creditor bail-in measure would be implemented as a condition for Fund lending in cases where, although no clear-cut determination has been made that the debt is unsustainable, the member has lost market access and prospects for regaining market access are uncertain."

The IMF does tone down this statement by saying that they would be mainly focusing on maturity extensions rather than outright debt write-downs and that they want to cushion the impact via other measures. Also, for now, this is nothing but a (let's say) discussion paper by the IMF, not a final policy document.

The bottom line is however that investors holding sovereign debt could be involved more frequently and at an earlier stage if things go wrong. Also don't forget collective action clauses that have been inserted in sovereign bond documentations. Covered bonds, on the other hand, have so far survived all sovereign rescues the IMF was involved in starting from Ireland, to Portugal, Greece and Cyprus.

As such, especially in weaker countries, these discussions should benefit covered bonds relative to sovereign debt and be looked at as an additional rationale for negative covered bond – sovereign bond spreads. Will they drive Pfandbrief – Bund spreads? Highly unlikely.

In essence, there are fundamental reasons why some covered bonds could and also should trade inside their respective sovereign debt. These factors are however not universally applicable, they have to be analyzed on a program by program level.

HOW DO INVESTORS REACT TO THIS SITUATION?

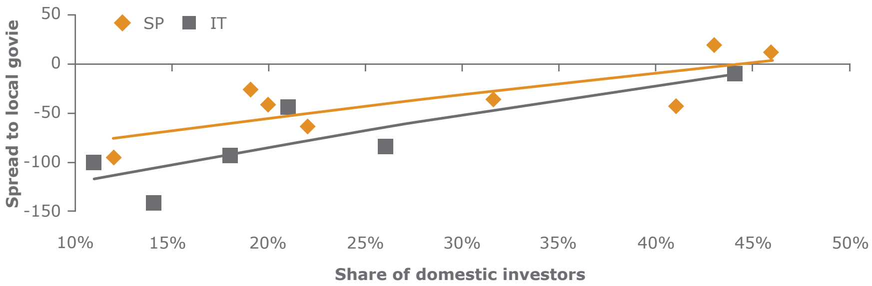
The last year or two saw a major shift in opinion on the part of investors when it comes to the acceptance of negative covered – sovereign bond spreads. What was initially laughed at as a technical market anomaly and then slowly accepted in secondary markets is by now broadly accepted for especially stronger issuers from peripheral markets amongst investors even in primary markets. The debate these days centers more around the question whether even weaker issuers from peripheral markets or covered bonds from core sectors should trade significantly inside sovereign debt, and in general how much inside sovereign debt covered bonds should trade before becoming too rich.

It is important to note at this point though that not all investors focus on the spread to local sovereign debt. Similar to some senior unsecured investors not caring much about covered bond levels and buying at very tight levels relative to covered bonds, there are investors who will not focus on the sovereign spread. The biggest focus on this relationship can probably be found among domestic investors. For many of them, the sovereign is still the relevant benchmark, and buying products that produce a significant negative carry vs. the investors' own benchmark is always problematic.

Consequently, when looking at investor distributions of 5-7Y EUR benchmark covered bonds from Spain and Italy in 2011-13, the share of domestic investors has become smaller the deeper inside sovereign debt a new issue was priced. What is relevant for domestic investors is, in some cases, not relevant for international accounts though.

In our experience, there are two motivations to buy covered bonds well inside sovereign debt at this point, one being more technical in nature and most likely a temporary phenomenon, while the other is very fundamental and not about to change anytime soon.

> Figure 10: Share of domestic investors and new issue spread to local sovereign debt



Sources: Moody's, Crédit Agricole CIB

There are investors who are literally being forced into covered bonds even at deeply negative spread levels to the respective sovereign for technical reasons without the portfolio manager believing the levels are fundamentally justified:

> Benchmarked covered bond investors have to have a sector weight in a given country and the alternative sovereign debt is not an investable alternative in that context. Take Italy as an example. There have not been very many OBG issues in recent months. Consequently, if benchmarked investors didn't want to fall behind their benchmark weight, they had to buy even deeply inside sovereign levels, as buying in secondary markets was even more difficult as well as even more inside the sovereign.

These investors bought covered bonds at deeply negative spread levels relative to sovereign debt but they were doing it more reluctantly than out of a very strong conviction.

The other group of accounts is however actually accepting the tighter spread because they fundamentally believe that the tighter spread makes a lot of sense.

> As mentioned above, bank treasuries consume less VAR limits for the covered bonds because of their stable spread performance and, on top of that, are in some cases able to actually generate more liquidity in repo operations with the ECB from covered bonds than from comparable sovereign bonds.

> Asset managers and above all some insurance companies are increasingly taking the view that the tail risk in covered bonds is lower than it is in sovereign debt. They therefore allocate a bigger portion of their long-term buy and hold investments in especially the higher risk countries towards covered bonds and away from sovereign debt. If one thinks in recovery terms and ignores the liquidity premium of covered bonds (as many of these investors intend to hold to maturity in any case), the flexibility to accept a negative spread to the sovereign bonds becomes very large all of a sudden.

Examples such as National Bank of Greece covered bonds and the Greek sovereign debt led to a reassessment on the potential outcomes if things get really bad. And comments by the IMF to involve investors in sovereign debt more often and also earlier in a sovereign debt restructuring add weight to the school of thought that covered bonds, especially if issued by systemically important banks and backed by residential mortgages (which are the most politically protected cover asset type there is), are in fact the least risky asset to hold in the end in distressed countries.

More and more investors are actually giving covered bonds a bigger role in the strategic asset allocation, representing stable core exposure to a certain country. Sovereign debt is increasingly being used as a tool for tactical asset allocation and implementing trading strategies. Obviously, we are not talking about a sudden shift, rather a gradual process, but it is happening nonetheless.

WRAP UP

The sovereign crisis has questioned many formerly unchallenged relationships in capital markets. Where sovereign debt was formerly considered to be the undisputed risk free rate in a given country and other products had to fall in line, there are by now selective covered bonds from mostly peripheral countries that trade at spread levels well inside their respective sovereign debt.

It would be naive to assume that covered bonds' risk is completely delinked from that of its sovereign. They are not immune to the development of the economic situation in a country due to the close link to the labour market, housing market, and the issuer itself. In addition, day-to-day trading activity in sovereign debt is higher than in most covered bond sectors, which means that liquidity premiums in sovereign debt should be lower than those for covered bonds. However, there are a number of benefits covered bonds enjoy relative to sovereign debt such as better stability in ratings and spreads, better ECB repo efficiency and potentially lower tail risk; thus, there are good reasons to invest in covered bonds even at these levels.

Which of these two lines of thought weighs more is essentially a case-by-case decision. Since the covered bond market is fairly heterogeneous, it would be the wrong approach to simply assume that all covered bonds have to trade similarly relative to their sovereign debt.

As a rule of thumb, the weaker the sovereign, the better and bigger the covered bond issuer, and the more the quality of the cover assets is delinked from the sovereign, the better the chances are for covered bonds to trade inside sovereign levels. In other words, covered bonds issued by national champions from the periphery backed by residential mortgages would be ideal candidates while public sector backed covered bonds by small issuers from stable countries should trade at a premium.

Balancing these reasons by taking single name credit profiles and investor specific preferences into account, the decision to invest in covered bonds trading below their sovereign can be a rewarding investment.

1.6 LIQUIDITY REGULATION, COVERED BONDS AND RELATIVE VALUE

1.6.1 COVERED BONDS TREATMENT IN THE LCR

By Florian Eichert, Crédit Agricole CIB

INTRODUCTION

Banks have traditionally been one of the largest investors in the covered bond market taking up to 45% of annual primary market issuance in recent years. As a result, everything that affects the behaviour of this investor base naturally affects the wider market as well.

One of the main issues driving banks' investments in covered bonds in the last months has been liquidity regulation or more specifically the Liquidity Coverage Requirement (LCR) which requires banks to hold liquid assets to cover stressed liquidity mismatches for a period of 30 days.

This article provides a brief overview as to where we stand with regards to covered bonds and the LCR. The base assumption has always been that covered bonds can be part of the LCR buffer and that they form part of the level 2 / category 2 assets depending on which terminology one uses (CRD IV or Basel III). The concrete treatment of covered bonds is still far from being certain though. There is not a lot of information out there and the few bits and pieces that do exist indicate that there still are significant differences between Basel III and the CRD IV. And as if this was not enough, even within Europe the EBA is only in the process of drafting technical standards which at the end of the day will have to survive another round of political negotiations between the European Council, Commission and Parliament that could once more change the situation.

This lack of certainty about how covered bonds will be treated for LCR purposes has been one of the main headaches many bank treasurers have faced. After all, how do you calculate and comply with a ratio if you do not know the individual components of the calculation, even if it is only for monitoring purposes for now?

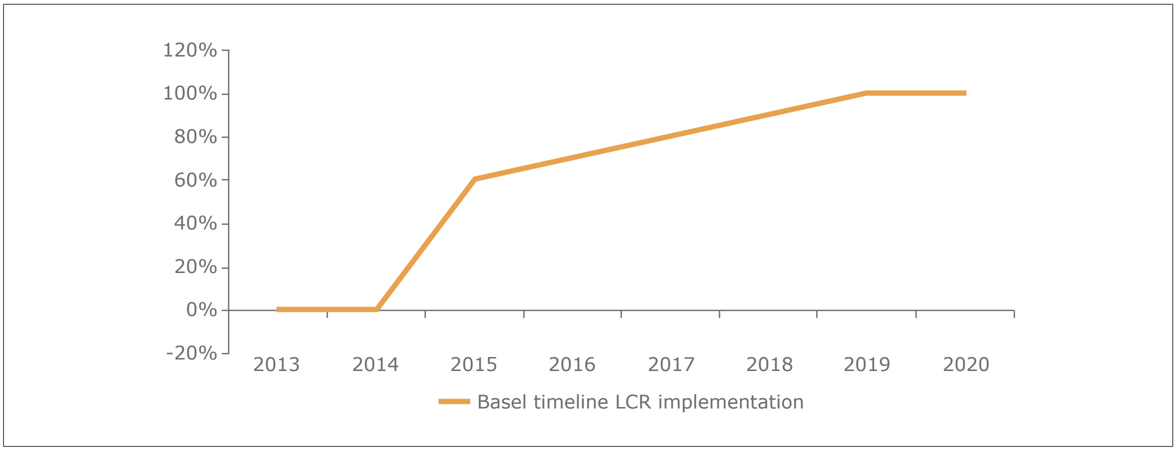
LCR IN BASEL III AND CRD IV – WHERE ARE WE NOW AND WHAT DOES THE TIMETABLE LOOK LIKE GOING FORWARD…?

Basel III

The initial LCR design under Basel III included a split of the liquidity portfolio into category 1 and category 2 assets with category one assets being mainly cash, central bank reserves and sovereign related debt. Covered bonds together with high quality corporate debt fell into the broader category 2 which at the same time had a minimum rating of AA-, a cap of 40% of the overall portfolio and assets in category two were subject to a 15% haircut. Full implementation of the LCR was scheduled for 2015.

At the beginning of this year, the Basel Committee surprised the market with, on the one hand, delaying the implementation of the LCR from full implementation in 2015 to a staggered implementation still starting in 2015 but not reaching full implementation until 2019.

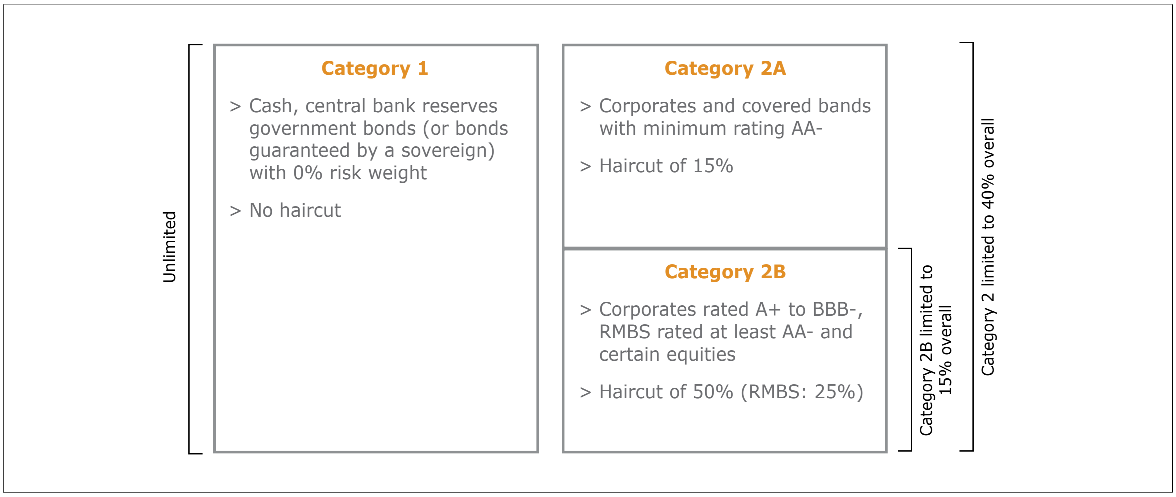
> Figure 1: Time frame implementation of LCR under Basel III



Sources: Basel Committee, Crédit Agricole CIB

On the other hand, the Basel Committee broke down category 2 into 2A and 2B and enlarged the set of potentially eligible assets to include assets such as RMBS. In the same context, it lowered the minimum rating on corporate debt down to BBB-. The focus has thus shifted somewhat from forcing banks into holding mainly sovereign debt to holding a more diversified portfolio reducing concentration risk and the link between sovereigns and their respective banks.

> Figure 2: LCR eligible assets Basel III proposals



Sources: Basel Committee, Crédit Agricole CIB

Surprisingly though, the Committee maintained the minimum rating for covered bonds at AA- despite reducing it for corporate debt to BBB-. One potential explanation could be the lack of available historical spread and trading data on below AA- rated covered bonds, as many of the downgrades only took place in the recent past. Corporate bonds have long been rated in the BBB area which means there is a much more stable data set that can be analysed. In addition to this technical issue, one has to keep in mind that the Basel Committee includes many members that do not have a sizeable covered bond market themselves or no covered bond market at all (the US for example). As a result, there is less urgency to protect the product, as is the case within the CRD IV at the European level. Despite having gone global by now, the largest covered bond markets still lie in Europe and this is where the product is still the most relevant for the underlying banking systems and economies.

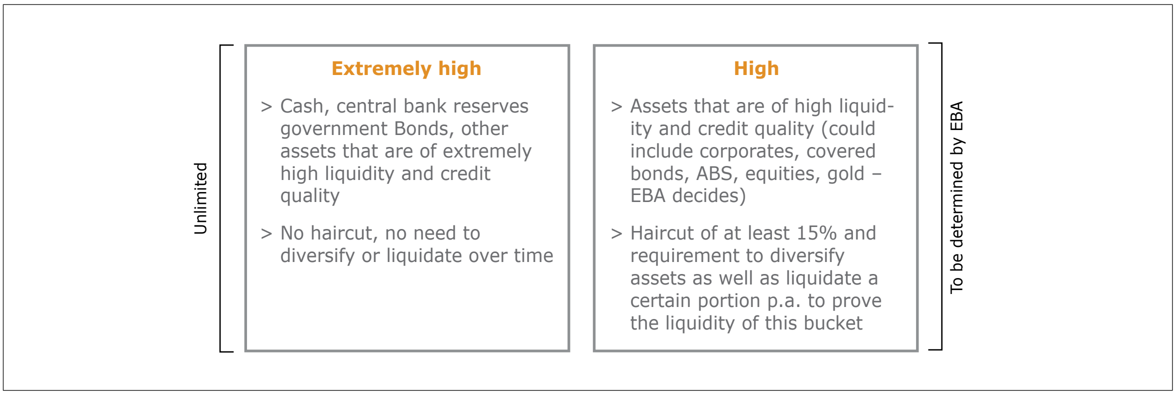
Even if the AA- should remain in the final text though, there could still a way out for lower rated covered bonds as "The Committee will continue to explore the use of market-based indicators of liquidity to supplement the existing measures based on asset classes and credit ratings".

CRD IV

The European Parliament passed the CRD IV package on 16 April 2013. It will come into effect on 1 January 2014. Liquidity regulation is covered in part 6 of the CRD IV package with the rules around the LCR in the CRD IV package being located in articles 411-426, 460-462 and 509. Covered bonds had always been mentioned in the context of level 2 assets. However, anyone looking for detailed rules on this in the CRD IV will be fairly disappointed. They are very high level rules with much of the detail work having been transferred to the European Banking Authority (EBA).

Article 412, for example, defines the way the LCR works in general, stating that banks will have to cover stressed liquidity mismatches for a time horizon of 30 days with liquid assets. Article 416 (1) then sets out to very roughly define which sort of assets can be used. Cash, exposure to central banks, central governments, SSA exposure as well as other assets of extremely high liquidity and credit quality (level 1 assets) are essentially what Basel would describe as category 1 assets while transferable assets of high liquidity and credit quality (level 2 assets) would be equivalent to category 2 in Basel Committee terms.

> Figure 3: Breakdown assets (excluding senior for example or own issued covered bonds)



Sources: CRD IV, Crédit Agricole CIB

Similar to Basel III, the focus of the CRD IV package has fortunately shifted from incentivising banks into holding only sovereign debt to fulfil the LCR requirements, to advocating for a more diversified liquidity buffer. In fact, the text reads rather refreshingly realistic:

> "As it is not possible to know ex ante with certainty which specific assets within each asset class might be subject to shocks ex post, it is appropriate to promote a diversified and high quality liquidity buffer consisting of different asset categories". (Recital 100)

> "A concentration of assets and overreliance on market liquidity creates systemic risk to the financial sector and should be avoided". (Recital 100)

> "EBA shall consider [...] other categories of assets, in particular residential mortgage-backed securities of high liquidity and credit quality, other categories of central bank eligible securities or loans, for example local government bonds and commercial paper, other non-central bank eligible but tradable assets, for example equities listed on a recognised exchange, gold, major index linked equity instruments, guaranteed bonds, covered bonds, corporate bonds and funds based on those assets" (Article 509(3)).

The introductory statement of the CRD IV package even opens the door to covered bonds being moved to level 1 under certain conditions:

> "When making a uniform definition of liquid assets at least government bonds and covered bonds traded on transparent markets with an ongoing turnover would be expected to be considered assets of extremely high liquidity and credit quality". (Recital 100)

Compared to Basel III, there is however no further split into 2A and 2B, no minimum ratings and not even a 40% limit on the maximum share of level 2 assets.

The CRD IV is instead handing over an extensive mandate to the EBA to come up with the detailed rules. Despite the opening remarks, there is at this point in time no way of telling how wide or how narrow the set of eligible investments and their respective treatment will be in the end. The EBA does have to take into account any potentially detrimental impact on business and risk profiles of institutions, financial markets or underlying economies (and it can be , for example, argued that implementing measures such as the AA- minimum rating from the Basel III recommendations would have exactly such a negative impact considering that the AA- eliminates Cédulas, OBG, ACS and Portuguese covered bonds from the liquidity portfolio altogether). It is still very hard to estimate at this point what the final outcome will be.

Article 509 clarifies the tasks as well as the related timeframes that the EBA has to take care of. In a nutshell, the EBA has to report to the European Commission on:

> The calibration of cash in- and outflows as well as potential inflow caps;

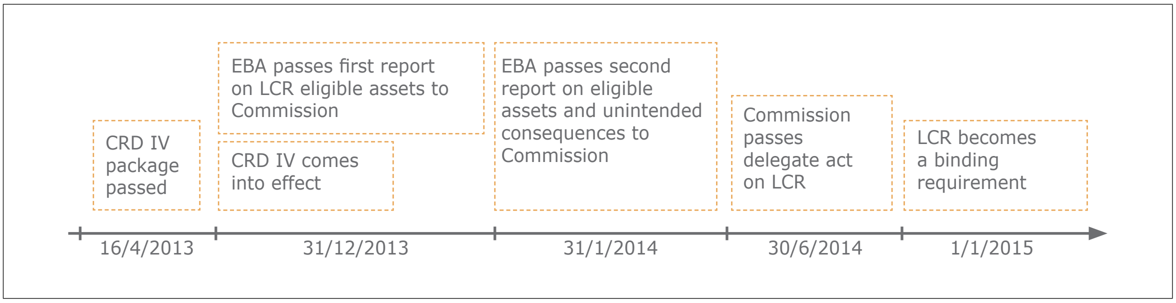
> The split between level 1 and 2 assets (which in the case of Basel has resulted in a 40% cap for the latter group of securities);

> Definitions of level 1 as well as level 2 assets; and,

> Appropriate haircuts for level 2 assets.

To do this, the EBA will have time until the end of this year. After consulting with the European Central Bank (ECB) and the European Securities and Markets Authority (ESMA), they will have to report their findings, for the first time, to the European Commission by the end of 2013. The EBA will then have to follow up with a somewhat more detailed report, which should also mention potentially unintended consequences by the end of January 2014. Both the European Parliament as well as the European Council will have time to review these reports and state their views.

> Figure 4: Timeframe CRD IV LCR implementation

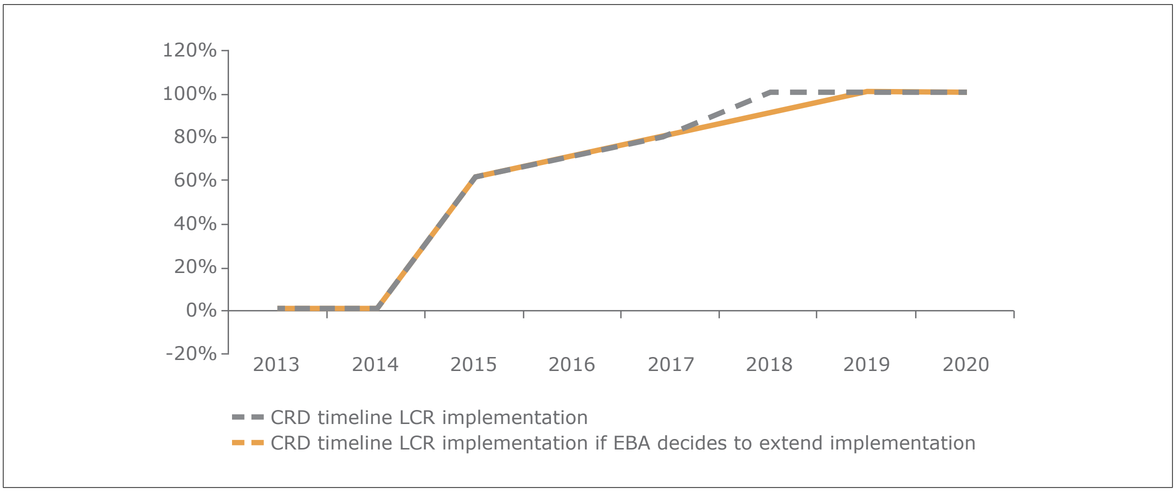


Sources: CRD IV, Crédit Agricole CIB

Finally, Article 460 empowers the European Commission to adopt a delegate act by 30 June 2014 specifying the detailed rules based on the findings of the EBA. At this last stage, politics come back into play as the Commission can very well divert from the EBA / ECB / ESMA proposals. In fact, their proposal is only one basis for the Commission to decide. It will also have to take into account international standards (such as Basel III) as well as Union specificities (such as relevance of covered bonds for the real economy or the overall rating situation). The delegate act would then enter into force by 31 December 2014 with banks applying it from 1 January 2015.

The stated goal in the opening remark of the CRD IV was to have one harmonised set of rules across Europe. As a result, once the delegate act is in force, there would be little, if any, differences in the way the LCR and LCR eligible investments are defined across Europe. Until that point however, national regulators have some flexibility and banks, such as the Swedes who already operate with an LCR since 1 January 2013, can use their own judgement in the absence of concrete rules.

> Figure 5: Timeframe CRD IV & LCR implementations



Sources: CRD IV, Crédit Agricole CIB

EBA Discussion Paper on defining liquid assets in the LCR under the draft CRR

As mentioned above, the EBA has to propose technical standards on the LCR to the European Commission. So how covered bonds will be treated will ultimately depend on the outcome of their analysis.

On 21 February 2013, the EBA issued a discussion paper on the subject in which they stated their objectives and outlined the approach they plan to adopt to identify level 1 and 2 assets. Their objectives of this exercise are:

> "(i) establish a ranking of asset classes based on their aggregate liquidity properties; and"

> "(ii) identify explanatory characteristics of individual securities that explain observed liquidity differences within asset classes".

To achieve this, the EBA plans to use a two step approach:

> "Assess a common set of liquidity metrics across all asset classes. These metrics will be computed first at the ISIN level, but the primary analysis will focus on aggregated results by asset class. An ordinal ranking of asset classes in terms of liquidity will be constructed".

> "Test whether explanatory characteristics of individual securities within each asset class can be used to predict their liquidity in quantitative terms. The EBA plans to attempt to construct definitions that should be fulfilled by individual assets within a particular eligible asset class, in order to be included in the liquid asset buffer as either transferrable assets of high or extremely high liquidity and credit quality".

In addition to the categorisation, the EBA also plans to determine the actual haircuts to be imposed on level 2 assets based on the same data set. The EBA does not plan to introduce a flat 15% haircut as is still mentioned in the Basel III text.

> "Finally, the analysis will identify the features that are of particular importance to market liquidity. Within individual asset classes that are found to contain assets of high liquidity and credit quality, appropriate haircuts will be proposed, based on the empirical evidence on historical price movements."

> Figure 6: Criteria taken into account by the EBA in determining technical standards for the LCR

Quantitative criteria	**Additional general explanatory criteria - referring to the market structure**
Minimum trade volume	
Minimum outstanding volume	Presence of a large number of market makers
Transparent pricing and post-trade information	Treaded via additional platforms and markets
Proven record of price stability	Wide range of potential buyers
Maximum bid/ask spread	Transparency
Average volume traded and average trade size	**Additional general explanatory criteria - referring to an asset**
Remaining time to maturity	Collateral eligibility
Minimum turnover ratio	Credit rating
	Issue size
	Remaining time to maturity
	Low complexity / standardisation
	Product specific regulation
	Proven track record of an asset class (length of the history of an asset class - for newer covered bond frameworks the lack of any history can be mitigated if structures are based on existing covered bond frameworks)
	Credit rating

Explanatory Characteristics for Covered Bonds
UCITS compliance
CRD compliance
Characteristic of the issuer
Characteristic of the collateral (type of collateral, LTV, NPL, ongoing valuation, overcollateralization, recoverability, geographical distribution of cover pool, allowed exchange assets, derivatives and securitizations in cover pool)

Sources: EBA, Crédit Agricole CIB

At this point it seems that the EBA would like to focus heavily on ex post turnover statistics and bid-ask spreads when determining the ultimate LCR treatment of individual assets. They then aim to run extensive quantitative analysis on these figures. Qualitative criteria mentioned in the table above are part of this exercise but, as things stand at the moment, they will not have a very important role in the process. All the EBA plans do with them is to back test if they have any statistical relevance to refine the interpretation of the turnover and bid-ask spread data, but they do not seem to have any decisive meaning in their own right.

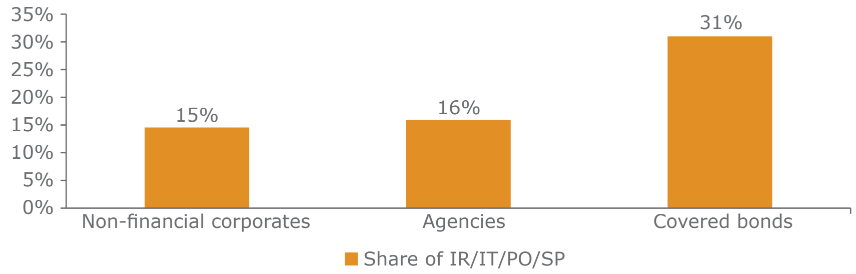
The EBA's ideal end situation would probably be a large database similar to the ECB's repo collateral database which would, on an ISIN level, determine both the treatment with regards to haircuts as well as to the category a bond falls into. Some covered bonds could make it into category 1, others would be in category 2 and maybe some would even drop out altogether. Haircuts would also not be a flat 15% as is still mentioned in the Basel III text but be determined by a bond's actual level of liquidity.

The proposed approach seems to focus too heavily on data that is still hard to come by and also hard to interpret. The LCR's purpose is to define assets that banks can liquidate if they need to, which means, the focus is on the bid only. As such, the EBA should focus on finding criteria that point to a strong structural bid for a particular product. Merely basing the LCR treatment on ex post trading turnover data may be misleading and might not capture the actual purpose behind the metric. Qualitative data which is crucial for investor demand in covered bonds should play a much more important role in EBA's approach.

When looking at the first covered bond purchase programme by the ECB or at late 2012 / early 2013 data, it can be observed that trading turnover was fairly low. Nevertheless, the reason for this was not the absence of buyers but rather the absence of sellers. Looking at turnover numbers and bid-ask spreads for these periods would probably lead the EBA to think that covered bonds were a rather bad asset to hold as a bank treasurer compared to, for example, corporate debt. In fact, however, the opposite would have been true as there was plenty of demand for the bonds.

In addition to this, starting with the asset class level to define the liquidity ranking will put covered bonds at a disadvantage compared to other debt types as, for example, the share of peripheral bonds is much higher in the covered bond market than in most other asset classes. The strength of the market (there is demand for these bonds while there is sometimes not for corporate or bank unsecured debt from these countries) would thus turn to be a disadvantage for the overall asset class.

> FIGURE 7: SHARE OF IR/IT/PO/SP IN IBOXX COVERED, AGENCY AND CORPORATE NON FINANCIAL INDICES (%)



Sources: iBoxx, Crédit Agricole CIB

Furthermore, other regulatory initiatives, such as bank resolution, or comments by the International Monetary Fund (IMF) about involving sovereign bond investors more frequently, and also earlier, in a sovereign debt restructuring are creating additional demand for covered bonds. This additional demand will add to the structural bid for the product but, since much of this demand would be buy-and-hold investments, it would be detrimental to liquidity considering the way the EBA is currently trying to measure it.

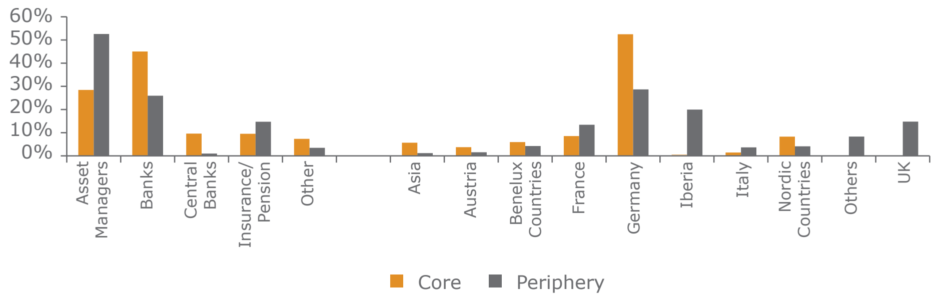
HOW ARE INVESTORS REACTING TO THE UNCERTAINTY?

Bank treasurers are looking to enter the covered bond market or to further familiarise themselves with an asset class that they already hold but plan to expand further. In most of these cases, the main motivation for doing so has been the potential LCR treatment of covered bonds. This trend has been prominent throughout 2012 but, despite the planned staggered implementation from 2015 onwards, has lost nothing of its momentum in 2013.

With all of the uncertainty around the treatment of covered bonds, the problem with buying potentially LCR eligible covered bonds is that there is no telling if all covered bonds will benefit from the same treatment. Looking at the Basel III proposals to introduce a minimum rating of AA-, large parts of the European covered bond market would not even be eligible as highly liquid assets and this would leave alone extremely highly liquid ones.

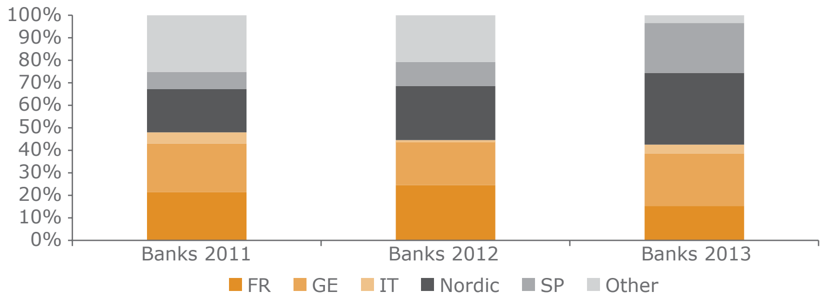
What bank treasurers across Europe, if not worldwide, are doing to minimise the risk of being caught off guard is that they hold on to the little bit of information that is out there and play it safe.

> FIGURE 8: INVESTOR DISTRIBUTION BY INVESTOR TYPE AND REGION FOR EUR BENCHMARK COVERED BONDS IN 2013



Sources: Bloomberg, IFR, The Cover, The Covered Bond Report, Crédit Agricole CIB

> FIGURE 9: REGIONAL BREAKDOWN OF MONEY SPENT BY BANK TREASURIES ON PRIMARY MARKET EUR BENCHMARK COVERED BOND NEW ISSUES



Sources: Bloomberg, IFR, The Cover, The Covered Bond Report, Crédit Agricole CIB

With the exception of bank treasuries from countries such as Italy or Spain, the main focus has been on buying stable core sector covered bonds with sufficiently high ratings to fulfil at least the initial Basel III recommendations. Looking at the money spent on EUR benchmark covered bond new issues in 2012 and 2013 by this investor base, one can see that the vast majority of money went to these low beta sectors. Over 50% of 2013 bank treasury investments in the first half of the year went to new issues from Germany and the Nordics. The share of purchases in OBGs and Cédulas mainly came from domestic treasuries who, in addition to the LCR argument, just simply want to diversify away from too much sovereign exposure.

This behaviour has kept spreads in core sectors very stable despite the volatility in other markets and has made issuers from the periphery rely on their domestic treasuries, as well as international asset managers and insurance companies to sell their bonds. It does not take much exaggerating to make the statement that the uncertainty around the LCR rules has split the covered bond market in two – core sectors which are dominated by banks and central banks as well as the periphery which is dominated by asset managers and insurance companies.

Is this situation going to change anytime soon? Not unless there is more clarity and, as mentioned above, this uncertainty is going to stay with us until well into the summer of 2014.

WRAP UP

Looking at the CRD IV rules as well as the EBA's work, one clear positive aspect at this point is the aim to avoid having too concentrated liquidity portfolios. Regulators have realised that forcing banks to hold only sovereign debt is not the best idea and that it actually increases systemic risk rather than reduce it. Early plans would have meant that everyone holds the same securities and, having to sell into an investor base that already has the same securities, it would have not exactly produced a very stable bid.

Unfortunately for now, this has not yet been translated into more clarity on covered bonds' treatment, especially in the context of the CRD IV. Will they be level 1, level 2, what will the haircuts be, will there be uniform treatment of the asset class, will there be differentiation down to the ISIN level? The uncertainty is especially high for lower rated covered bonds that would not meet the current AA- minimum rating from the Basel III text. Many covered bonds had been downgraded to these levels because of lower sovereign debt ratings. Cédulas or OBGs, for example, had in fact been victims rather than criminals in that context. All of this is still not reflected in the latest Basel III text however (with the lower rated and more volatile sovereign bonds making it into category 1 and the respective covered bonds being left out altogether) and completely unclear in the CRD IV context.

Looking at the work done by the EBA so far, it seems to be focussing a lot on ex post trading turnover statistics. It is, however, an illusion (as well as not the purpose of the LCR) that liquidity regulation can protect banks in a systemic market crisis. Liquidity in virtually all markets dries up in these cases and central banks are there to prevent a collapse of the system. The LCR is meant to be dealing with individual banks running into liquidity problems. It is idiosyncratic rather than systemic risk here.

So what regulators should rather be looking at is the potential bid for and stability of a product. Covered bonds, especially lower rated ones from the periphery, have in that sense even been superior to their respective sovereign debt in the past months. For example, spreads have been significantly more stable and more investors have been focussing away from sovereign debt towards covered bonds as, in their eyes, they represent the least risky asset from a country. And looking ahead, regulators are doing almost everything to increase the chances for a stable bid for covered bonds.

Discussions by the IMF about involving private sector investors more frequently and also earlier in sovereign debt restructurings, as well as resolution regimes and moving depositors ahead of senior unsecured investors all add to the appeal of covered bonds for a wide set of investors.

Many of these additional accounts are, however, not trading accounts but would rather hold covered bonds to maturity. Trying to measure the product's worth for LCR purposes on the basis of trading statistics is therefore always going to be misleading. Qualitative criteria should thus play a much more important role in determining covered bonds' LCR treatment than what EBA is currently discussing.

Covered bonds have always been mentioned in the context of level 2 / category 2 assets. Looking at the recent discussions this is also where they (or at least the bulk of them) will probably end up as well. If the EBA continues to go down the same route they have laid out in their discussion paper published in February this year, we could end up having fairly differentiated results. Some covered bonds might even make it into level 1 while others might be ineligible altogether. This would not be the first time that Europe is aiming for more differentiated treatment of covered bonds. The EBA has also been mandated to reassess risk weights of covered bonds and will have to take into account the actual quality of the underlying framework and cover assets.

One decision that could take a lot of the relevance of the categorisation away would be if the EBA increases the ceiling for level 2 assets from the 40% mentioned in both the CRD IV as well as the Basel III recommendations. A move like this would both be positive for the diversification of liquidity buffers and would help countries who do not even have sufficient volumes of sovereign debt to fulfil their LCR needs.

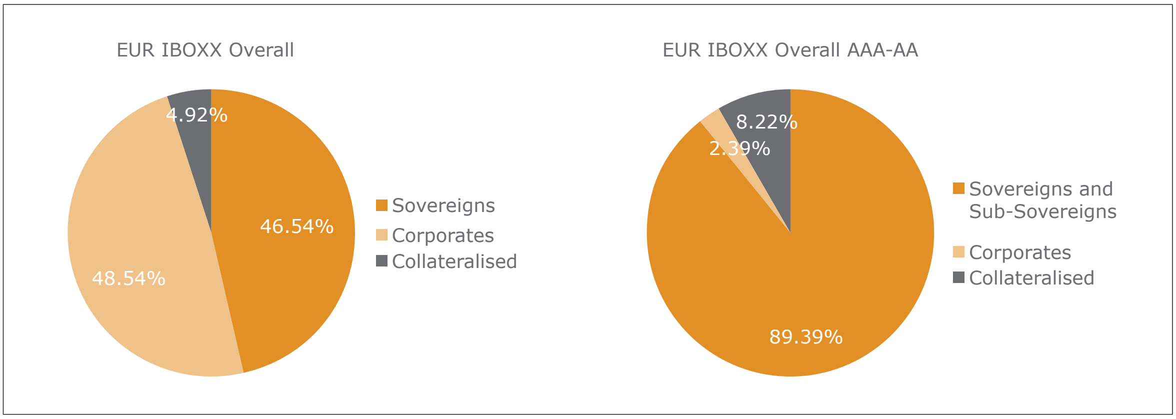
Whatever the final outcome, the LCR is going to continue to be one of the main drivers of bank investors in covered bonds going forward. The huge amount of uncertainty will however keep investors in a situation where they do not want to become too fancy in anticipation of what might happen. They will rather continue to play it safe and focus on core sectors until they have final clarity. Hopefully that will be the case sometime in 2014 if Brussels sticks to its timetable to pass the delegate act by the end of June next year.

1.6.2 RELATIVE VALUE ANALYSIS

By Ulrike Hock, UBS[1]

The covered bond market's share of the overall credit market has increased significantly over the last few years. Growth in recent years has shifted from Europe to new countries while, at the same time, the investor base has become more global too. Below we highlight some key drivers of the covered bond market.

> FIGURE 10: EUR IBOXX ALLOCATION OF SOVEREIGN, CORPORATE AND COVERED BONDS (ALL AND IN RANGE OF AAA-AA)



Source: UBS Delta, iBoxx , 2013-04-22

MAIN DRIVERS ON THE COVERED BOND MARKET

The fundamental and regulatory landscape for European banks has changed dramatically since the 2008-2009 financial crisis. In a nutshell, fundamentals have been weak especially in the periphery countries and capital requirements have risen significantly. In addition, ratings pressure has been strong due to a wave of broadly based downgrades of sovereign, financial and covered bonds over the last few years.

Covered bonds are one of the asset classes that benefits from a clear regulatory recognition. While most covered bonds used to be rated AAA a couple of years ago, the reality is very different today. Note that ratings changes for covered bonds have also been driven by some rating agencies changing their rating approaches.

In short, rating agencies have given more weight to the links that exist between the following elements: the issuer and cover pool quality, the likelihood of a government support, pressure by bail-in regulation, legal structures, the development of ratings and regulatory needs. As a result, spread volatility of covered bonds has risen.

Spread drivers can be ranked over the last few years as follows:

> Superior and domestic regulatory issues

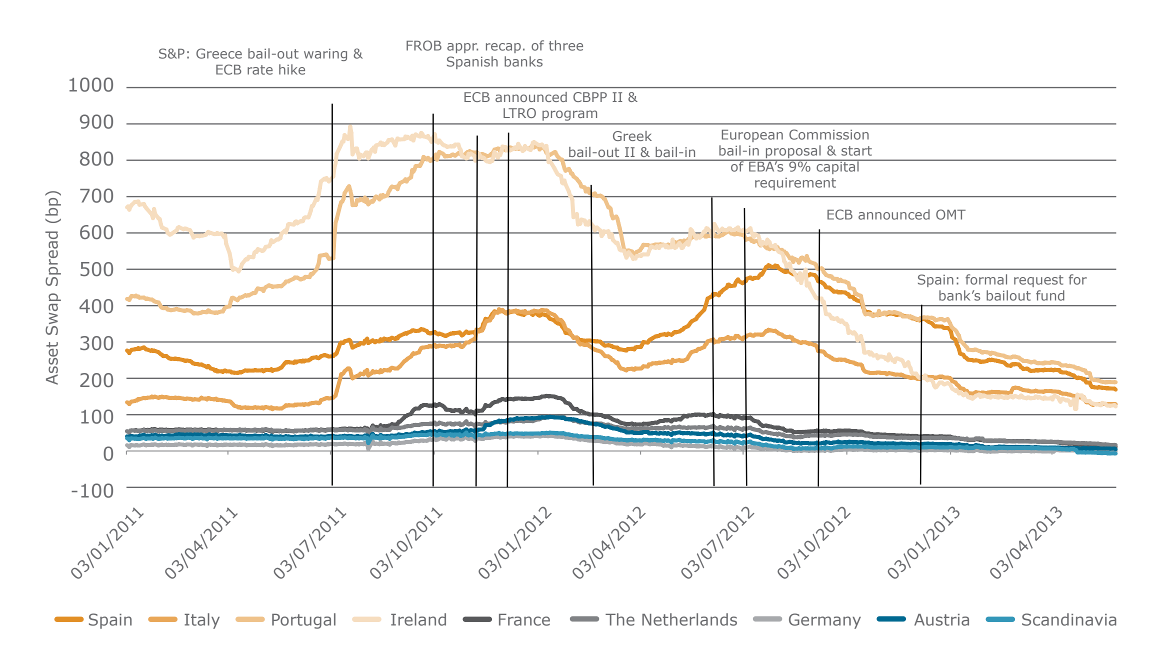
> Issuer fundamental factors and country specific issues

> Rating changes (especially downgrades)

1 This article draws on material from UBS Investment Bank. The views and opinions expressed in this article are those of the authors and are not necessarily those of UBS. UBS accepts no liability over the content of the article. It 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.

Figure 11 below highlights the most important spread driver events.

> Figure 11: Historical covered bonds spreads (based on ASW) and spread driver events



Source: EBA, EC, ECB, IMF, Eurogroup, Bank of Spain, FROB, FT, Bloomberg, UBS
Note: this is a snapshot of the market, country data as average data

Superior and domestic regulation

The legal base of covered bonds was historically a key pillar of spread stability vs. other assets classes. But with the evolution of the sovereign crisis, the preferential status and full repayment characteristics of covered bonds have been put into question. For example, (i) when banks have been nationalised or processed and (ii) by a country bail-out (e.g. in case of Greece).

On the other hand, some countries have implemented stricter rules or additional laws, e.g. Germany introduced the German banks restructuring law in 2010 (bail-in law), which has added another layer of protection for covered bondholders (German Pfandbriefe). In parallel, some European banks had reached a state of insolvency prompting the European Commission to prepare a European "bail-in" directive (the proposal was published in June 2012). Further, the ECB has started working on a bank single supervision mechanism and the EBA was founded. The results of the EBA bank stress tests were also important spread drivers during the last two years.

Spreads have also been importantly affected by the ECB's unconventional monetary policies in particular the Long-term Refinancing Operation (LTRO) programme (first announced in November 2011) and the Outright Monetary Transactions (OMT) programme in September 2012. Both measures gave market participants confidence and the LTRO programme led furthermore to a significant lack of supply of covered bonds which supported spreads in 2012.

Fundamental issues

The rise of already elevated unemployment rates is also a relevant driver for spreads; however, other factors have impacted spreads more materially in recent years. The focus has shifted away from country fundamentals to more bank-specific quality factors. As a result, the published results of the EBA's various stress tests have been outlined as much more relevant. When the EBA released the first stress test results in July 2011 peripheral spreads widened significantly (which was additionally affected by ECB's rate hike and S&P's bail-out warning for Greece). The reaction to the second report in October 2012 was similarly important but was tempered by the ECB's OMT announcement one month before.

The increase of the sensitivity of weak banks' fundamental events could have only been increased by even more significant incidents on the government side (deficit and / or debt situation), e.g. by the Greek bailout II in February 2012. Single issuer events haven't affected the total market or its region respectively since the ECB's major willingness to support the financial system in 2012.

Rating changes

The broad rating downgrade cycle across the sovereign, issuer and covered bond spaces has not only been driven by the deterioration of fundamentals but also by changes in rating approaches (or parts thereof) over the last few years.

Covered bond spreads have been mainly affected by rating changes (mostly downgrades) of sovereigns, followed by issuer rating downgrades. Ratings of covered bond programmes have mostly been downgraded just days later.

The largest spreads reactions occurred in cases of combined regulatory, fundamental and rating issues. For example, in the distressed markets between March and July 2012 the following events took place:

> Capital needs of several banks;

> Government support for these banks; and

> Start of the EBA 9% capital requirement.

SPREAD DEVELOPMENT OF COVERED BONDS COMPARED TO GOVERNMENT BONDS

The relationship between covered bond and government bond spreads has changed significantly since the start of the financial crisis.

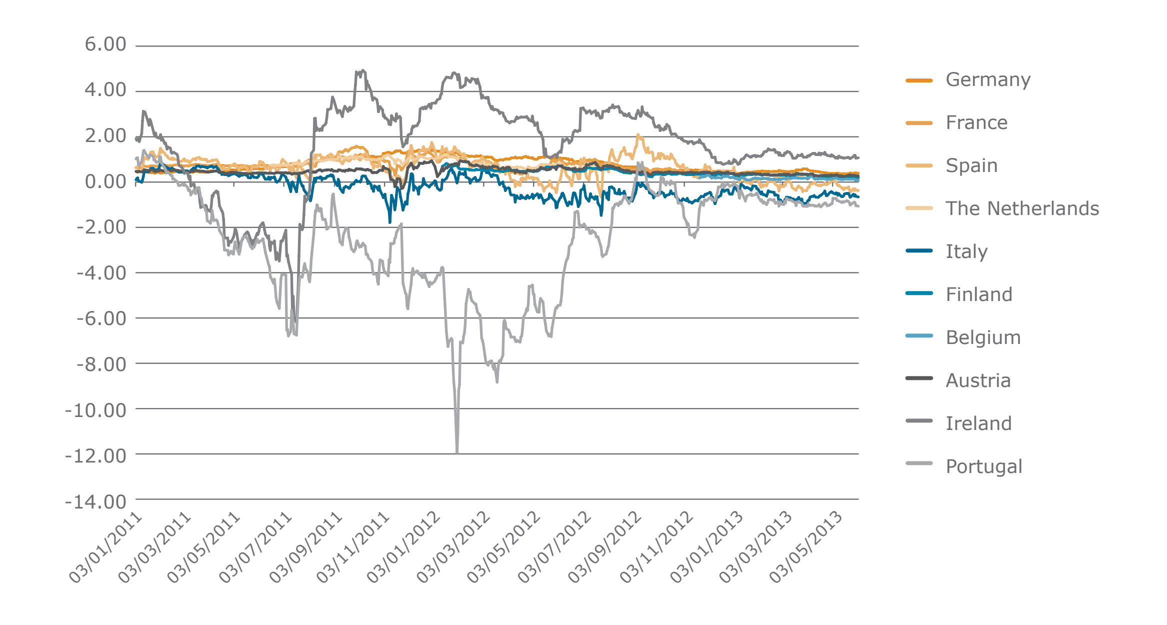
Under the efficient market hypothesis there should be a positive spread between governments and covered bonds, as governments represent a safer investment product for bondholders than covered bonds. Over the last few years the situation has changed due to:

> The bail-in of distressed sovereign bondholders in Europe (Greek bailout I in 2010 and the 53.5% haircut for bondholders in Greek government bonds by the Greek bailout II in 2012) and more generous tender offers/redemptions for covered bonds (e.g. the tender offer of one Greek issuer to buy back at 70% of par value) have resulted in a preference for covered bonds vs. troubled government bonds.

> The temporarily much higher bid-offer spreads of covered bonds compared to government bonds have been established as a stabilisation factor for covered bonds during times of weak country sentiment. Volatility increased in governments, because of their higher liquidity and lower bid-offer spreads.

Since 2011, covered bond yields (especially these of the national champions) have tended to be lower than their domestic government yield when market sentiment vis-a-vis sovereigns is weak.

> FIGURE 12: HISTORICAL SPREADS BETWEEN COVERED BONDS AND GOVERNMENT BONDS (IN % OF MID YIELD, COUNTRY AVERAGE)



Source: Bloomberg, UBS

Note: (1) This is a snapshot of the market, country data as average data;

(2) The average of Ireland is based on mortgage covered bond programmes only and interpolated government curves

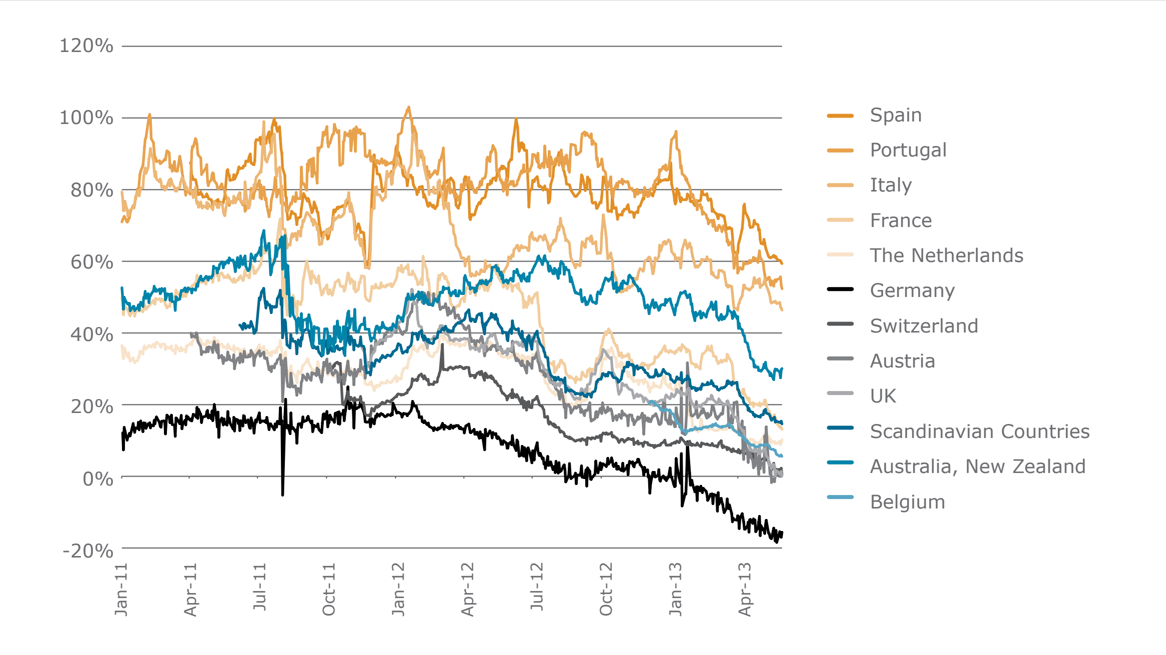
COVERED BONDS COMPARED TO SENIOR FINANCIAL BONDS

Under normal conditions the yields of senior bonds should be much higher than those of covered bonds. This assertion holds for most countries in Europe but not necessarily in peripheral countries. Figure 13 shows the percentage of an issuer's covered bonds outstanding vs. the issuers' senior bonds outstanding. When the value is close to 100% then the spread levels of both asset classes are approximately the same.

During the last few years, in some cases, the spreads were temporarily negative. One reason might be the different market size of both asset classes, especially in some peripheral countries (e.g. less or no outstanding senior bonds compared to covered bonds). And, secondly, apparently also a various risk aversion view, e.g. when rating levels have changed below BBB-/Baa-.

The situation has started to change since mid-2012, when the European Commission published its draft for a "bail-in" regulation. Since that key event, spreads have widened across the countries, especially for those market segments targeted by the bail-in regulation.

> Figure 13: Historical spreads between covered bonds and senior bonds



Source: Bloomberg, UBS
Note: this is a snapshot of the market, country data as average data

1.7 PRE-INSOLVENCY PROCEEDINGS AND REGULATORY CHANGES – CHALLENGING TIMES FOR COVERED BONDS

By Heiko Langer, BNP Paribas and Alexandra Schadow, LBBW

Covered bonds are designed to protect investors at times of stress. This means protection from loss of capital and interest but can also mean protection from larger market price movements. If we look back at the financial crisis, it is fair to say that covered bonds have lived up to their promise of protecting bondholders, especially when compared to holders of unsecured bank debt.

During the global financial crisis, covered bonds have been spared the real test, as overall support for banks has been relatively high which prevented scenarios where covered bondholders had to rely on the collateral. Going forward, this is likely to change due to reduced willingness and ability of governments to support failing banks. In fact, one of the main challenges that lie ahead is the changing regulatory environment, which also affects covered bonds in various ways. In the following article, we take a closer look at the impact that pre-insolvency proceedings on troubled banks can have on covered bonds. Furthermore, we discuss the changing regulatory environment, namely Resolution Regimes, Banking Union and the Liikanen Report and their potential impact on covered bonds.

IMPACT OF PRE-INSOLVENCY PROCEEDINGS

Post-bankruptcy procedures are an important feature of covered bonds since they provide the mechanics of asset segregation, cover pool administration and payments to covered bondholders in the case of an issuer default. The differences in post-bankruptcy procedures between jurisdictions can be substantial with potentially significant implications for covered bondholders. The potential impact of hard bullet vs. soft bullet maturities on cash flows in a post-bankruptcy scenario is just one example for such differences. It is thus understandable that post-bankruptcy procedures become under increased scrutiny by market participants in times of stress and deteriorating creditworthiness of the issuer. However, it is worth highlighting that even during the last financial crisis post-bankruptcy procedures have not been tested despite the fact that several banks faced difficulties which forced them to seize business activities.

Following the bankruptcy of Lehman Brothers in 2008 and the shock waves it produced in the financial markets, significant endeavours were taken by governments and regulators to avoid any further uncontrolled bankruptcies. This meant that troubled banks, including those that had covered bonds outstanding, were either nationalised, received other forms of public sector support or were merged with other institutions. All of these measures meant that a segregation of cover assets from the issuing bank was avoided and post-bankruptcy procedures were not applied. While the avoidance of a bankruptcy event is a positive outcome also for covered bondholders, it does not mean that the covered bonds are completely unaffected by the rescue measures. Especially the orderly wind-down of a bank, be it as a result of a nationalisation or the decision of its owners to no longer continue with the business, can have an impact on rating, liquidity and cover pool composition of the covered bonds. We take a closer look at the potential ramifications of an orderly wind-down of the issuing bank on its outstanding covered bonds.

IMPACT ON RATINGS

If an issuer of covered bonds is in an orderly wind-down, it means that all lending activity is stopped in order to avoid unfair competition with banks that have not received public sector support. While the issuance of new bonds, in order to replace maturing bonds, may not necessarily be seen as continued business activity that leads to unfair competition, most issuers that have been put into orderly wind-down have stopped issuing new covered bonds.

The fact that issuers in orderly wind-down are usually not returning to the bond market can have noticeable implications on the outstanding bonds previously issued. The ratings of the covered bonds are one of the most visible features that can be affected. Issuers that are in a wind-down scenario are likely to already have faced rating pressure on their senior unsecured rating given the financial difficulties that ultimately led to the wind-down. This means that the covered bonds may have faced some rating pressure as well. However, the covered bonds may still be rated several notches above the issuer's unsecured rating.

In order to optimise market access and to achieve favourable funding costs, issuers usually try to achieve the highest possible ratings for their covered bonds. This entails mainly the use of voluntary over-collateralisation, i.e. collateral in excess of the volume that is required by the covered bond framework or programme. Where market access is no longer needed or indeed wanted, issuers may choose to no longer provide over-collateral in an amount necessary to achieve the highest possible rating but to reduce it to the legally or contractually required minimum. Reducing the over-collateral to the legally prescribed minimum limits the rating uplift that the rating agencies provide for the covered bond rating above the senior unsecured rating of the issuer. In some cases, the rating uplift for the covered bonds can be reduced to zero notches, which means that the covered bonds would be rated at the same level as the senior unsecured debt of the issuer.

LIQUIDITY

A continuous absence from the primary market can also have an impact on secondary market liquidity of outstanding bonds of an issuer in wind-down. Some market participants (institutional investors but also banks that trade covered bonds) may be unwilling to provide and maintain credit lines for issuers that no longer provide investment opportunities in the primary market. This means that such lines may be closed once existing bonds have matured or have been sold and the investor or trader is no longer able to buy bonds of the issuer in question, even if they would be offered in the secondary markets at some point. In addition, market makers are less willing to provide liquidity to bonds of issuers that are no longer active in the primary market. In particular, market makers will avoid engaging in short positions of bonds, when it is clear that the issuer will no longer increase such outstanding bonds, a practice that is already relatively rare even with bonds of issuers that are not in wind down. The absence of regular new issuance also means that there are no longer any recent pricing points that reconfirm or adjust the price levels seen in the secondary market. This increases the reluctance of market makers to quote tight bid offer spreads as the uncertainty about tradable prices is relatively high.

COVER POOL COMPOSITION

While the cover pool becomes static in a bankruptcy scenario where the cover pool is segregated from the balance sheet of the issuing entity, the dynamic nature of the pool prevails in an orderly wind-down of the issuer. This means that the bank in wind-down is still responsible for keeping the cover pool at a qualitative and quantitative level that complies with the legal or contractual framework. Especially in cases where an asset cover test is conducted (e.g. in the United Kingdom or the Netherlands) pre-bankruptcy coverage requirements are stricter than in a post-bankruptcy scenario. For example, loan-to-value limits can be higher in an amortisation test (i.e. post-bankruptcy) than in an asset cover test (i.e. pre-bankruptcy). In addition, the treatment of non-performing loans in the pool can be more lenient in a post-bankruptcy scenario, which means that they may still fully count as collateral to pass the amortisation test.

As shown above, preserving the dynamic nature of the cover pool by putting the issuer in orderly wind-down has distinct advantages for the quality of the pool. However, the fact that the issuer is usually not conducting any new lending business once it is put in wind-down means that the overall scope for asset substitution within the pool is limited. In the case of deteriorating asset quality in the pool, lack of available unencumbered collateral could ultimately lead to a scenario where further external support will be necessary to either add substitution assets such as cash or government bonds or to buy back outstanding bonds in order to avoid a breach of coverage requirements. However, even where the cover pool is performing well the lack of asset origination can have an impact on the composition of the cover pool. For example, a geographically well diversified cover pool can develop concentration risk over time if cover assets do not mature in a diversified manner. Maturing assets can also affect the credit profile of a cover pool if, for example, it contains mainly high quality assets with short maturities and low quality assets with long maturities. Admittedly, the risk of changing risk profiles caused by maturing cover assets is larger for less granular international cover pools, which are more typical for commercial mortgage or public sector collateral, than for granular domestic cover pools, which usually can be found in residential mortgage collateral.

WIND-DOWN IS THE LESSER EVIL BUT REGULATORY CHANGES INCREASE UNCERTAINTY

Despite the negative implications that an orderly wind-down has on covered bonds, they can be seen as the lesser evil compared to the repercussions of a bankruptcy of the issuer and the associated segregation of cover assets from the balance sheet. While spread levels of covered bonds from an issuer in wind-down usually do not return to the levels observed in other covered bonds, they are significantly tighter than those levels before the measures were taken that led to the wind-down of the issuer. Even though the wind-down scenario is not always a permanent solution, which means that a level of uncertainty about future ownership remains in cases were a nationalised issuer needs to be reprivatised, the stabilisation provided by the rescue measures are beneficial to the broader market.

The fact that a test of the covered bond concept through the segregation of assets has so far been avoided does not mean that post-bankruptcy procedures have become less important or even obsolete. As the ability and especially the willingness of governments and regulators to rescue failing banks has decreased significantly in recent years, the possibility of an actual test of the covered bond concept has become more likely. The planned introduction and international harmonisation of resolution regimes for failing banks is a clear sign that reliance on external support is decreasing while the importance of collateralised bank debt is increasing.

A first step designed to bring the European financial system under joint supervisory structures was already taken in 2011, when the Community created the European System of Financial Supervision (ESFS). The European Systemic Risk Board (ESRB) and the three supervisory authorities EBA (European Banking Authority), ESMA (European Securities and Markets Authority and EIOPA (European Insurance and Occupational Pensions Authority) have created a system that monitors macro prudential risks and is responsible for the implementation of specific requirements by means of technical standards within the European Union. The legally binding supervisory functions remain a national task, which has resulted in different courses of action being pursued in the individual member states. These differences became evident particularly in a stress case.

EUROPEAN BANKING UNION

The call for a European banking union was associated with the idea of an effective and uniform mechanism that will lead to integration of the banking systems in the euro currency area. In addition to its binding character on the 17 euro countries, it provides for the voluntary participation of the remaining European Union member states. The draft envisages that within this system all banks, financial holding companies, mixed financial holding companies and financial conglomerates (hereinafter 'institutions') that are domiciled in the participating countries are treated equally in terms of supervision, possible resolution and deposit guarantee. The banking union is thus based on three pillars: the Single Supervisory Mechanism (SSM), Single Resolution Mechanism (SRM) and Deposit Guarantee Scheme (DGS). While the latter two are currently the subject of lively debate at a political level in some instances, a compromise has been reached with regard to the SSM. However, the Directive has not yet been finally adopted. Moreover, a Commission proposal for a directive establishing a framework for the recovery and resolution of credit institutions and investment firms was submitted in June 2012. It is designed to create a uniform framework for recovery and resolution in the national legislation.

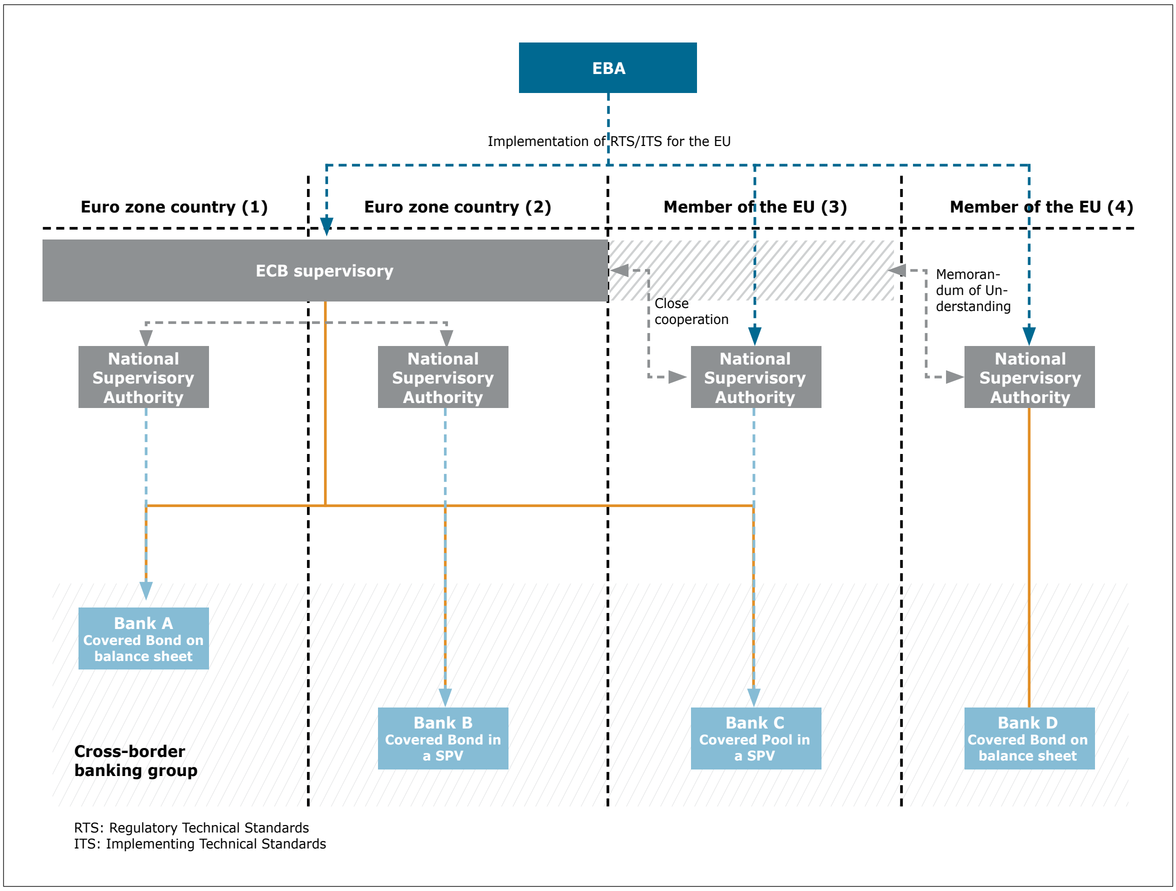
SINGLE SUPERVISORY MECHANISM (SSM)

Let us begin with the planned Single Supervisory Mechanism (SSM). Credit institutions domiciled in the euro area and with consolidated total assets totaling more than EUR 30bn or more than EUR 5bn and amounting to 20% or more of the GDP of the country in question are to be placed directly under the supervision of the ECB. Furthermore, institutions that have received public financial assistance from the EFSF (European Financial Stability Facility) or ESM (European Stability Mechanism) will in future also be supervised by the ECB. Independently of the said criteria, the ECB assumes the supervisory tasks for the three most important institutions in each participating member state. All told, there will probably be approx. 150 institutions. However, the ECB moreover reserves the right of immediate intervention in all institutions within the eurozone. This arrangement leads, depending on the size and home country of the financial group, to a large number of different categories of institutions in whose supervision several agencies are involved. It also affects covered bond issuers for whom the relevant supervisory authority is defined depending on their size. Due to the very different structures that are possible on the European covered bond market this provision is likely to mean that the way in which the covered bond is embedded in the institution in question will be of decisive relevance in determining whether or not they are supervised by the ECB. Here we might think of the issuers that hold the cover pool and covered bonds on the bank's balance sheet, in contrast to jurisdictions that have transferred the cover pool to an SPV. The likelihood of the latter being placed under the direct supervision of the ECB is substantially lower than for the first-mentioned covered bond issuer. Another important point is the specific bank supervision for covered bonds that is demanded by the UCITS Directive in section 52 (4). This specific supervision by the national supervisory authorities is not explicitly referred to in the draft. As we see it, centralization of this special task harbors the risk of the very specific regulatory issues being diluted. For this reason, this task should remain with the national supervisory authorities.

All in all, the call for equal treatment while at the same time observing and maintaining the very different business models in existence across Europe is becoming more explosive. The principle of equal treatment could, however, support the harmonization of the covered bond legislation in Europe that has already been demanded by some in the medium term. It is questionable whether the covered bond structures, which were in some cases conceived very differently in their origins by the national legislations, can in fact be treated equally. To do justice to these national specifics, we think that, above all, two things will be required: know-how and highly efficient communication processes. The build-up of know-how at the ECB is in its very early stages. It can therefore be assumed that the national supervisory authorities will retain high priority for the time being. For the communication and decision-making processes clear and binding rules must be established.

The example of a cross-border banking group in the eurozone illustrates this challenge:

Banking group A domiciled in a eurozone country (1) and total assets of more than EUR 30bn has three subsidiaries B, C and D. Bank B is also domiciled in a eurozone country (2) and is one of the country's three largest institutions. While institution C with total assets of more than EUR 30bn is domiciled in a union country (3) that participates in the banking union, institution D is domiciled in a union country (4) that does not participate in the banking union. All institutions A, B, C and D use covered bonds as a funding tool in accordance with their country's very different national provisions.



Source: LBBW Credit Research

The future tasks of the ECB/SSM include the authorisation of banks and the withdrawal of their license through the examination of qualified buying and selling of equity holdings to the adherence to regulatory provisions with regard to funds requirements, securitization, large exposure limits, liquidity, leverage and reporting and public disclosure. In this context the EU directives and regulations are decisive, supplemented by national provisions. A major component here is adherence to the provisions of the CRR/CRD IV package. In this context, the technical regulation and implementation standards to be worked out by the EBA are also decisive. The ECB's supervisory powers are very extensive in this regard. Admission takes place on the basis of a draft decision prepared by the national supervisory body. As we see it, however, this raises the question whether the usual practice of granting a special license to covered bond issuers in some countries will in future need to be also approved by the ECB. The ECB can withdraw the approval for a bank. If a bank is resolved, the withdrawal of the license can be postponed within an agreed period following application by a national agency. As we see it, this provision is due to the fact that there is as yet no Single Resolution Mechanism (SRM) in Europe.

Another material point that is also relevant for covered bond issuers concerns the options available to the ECB if a bank does not comply with union law such as e.g. CRR/CRD IV or is likely to be at risk of not being able to do so in future. This includes, among other things, obligations for higher equity also beyond the legally required extent, provisions on provision policy or on the treatment of assets, restrictions of business areas, sale of business areas or provisions for specific liquidity requirements. Such intervention can also have a huge impact on the business model of banks. As we see it, the above-mentioned examples certainly have the potential to influence the management of cover pools and thus the funding source which is covered bonds, either directly or indirectly. Estimating and managing these interventions on the basis of the EU directives and EU regulations requires, in particular, a deep knowledge of the national special characteristics and the legislation that implements and/or amends union law.

UNIFORM RESOLUTION OF BANKS (RRD)

The predominant topic in connection with the banking union is likely to be the uniform handling of a bank’s resolution. The first step in this direction was the Commission proposal for a directive establishing a framework for the recovery and resolution of credit institutions and investment firms (RRD) that was submitted in June 2012. Of the four resolution instruments – sale of business, bridge institution, asset separation and bail-in - the focus has been on the latter, in particular. In the initial draft no mention was made of covered bonds. It only referred to secured liabilities. As a further step, the Commission clarified that secured liabilities also include covered bonds. A discretionary scope was provided for these so that in the event of a shortfall of cover the partial write-down of covered bonds can be dispensed with. However, the relevant passage was amended and this sentence changed; according to the current proposal covered bonds could thus participate in a bail-in. However, for this to happen the liability in the shape of cover bonds would need to exceed the value of the cover pool. Only the difference between the liability and the associated asset would be included in a partial write-down. In this context the valuation question would become a key topic, as determining the valuation of the cover pool defines this possible gap between asset and liability position. This theoretical possibility of a bail-in of covered bonds ahead of a separation and thereafter insolvency of the existing cover pool, would, in our opinion, contradict the most important legally binding product features of covered bonds. Moreover, this approach would not be compatible with the principle of “not worse off” which ensures that covered bond creditors in the event of a resolution must not be worse off than in the event of a bank insolvency. The negotiations concerning the RRD are not yet concluded, further agreement rounds are to follow. In this process, the target conflict between harmonization, on the one hand, and taking into account national flexibility, on the other, is to be resolved. This balancing act between national interests and the call for a level playing field will, we think, almost certainly take some more time. However, politicians have exerted substantially more pressure of late so as to ensure that an agreement is reached by the end of June.

In view of the great importance of covered bonds as a funding tool for banks, particularly in crisis times, and its high reputation among investors we think that it is to be expected that the Directive will ultimately protect covered bonds against possible bail-in measures. Only then would the EU Directive, which needs to be transposed into national law, fit in with the covered bond legislations in question. They demand, albeit in different ways, the unconditional special status and protection of the cover pool in connection with covered bonds. A further point of debate that emerges in this connection is the treatment of overcollateralization in the cover pool. In addition to the minimum cover required by law, there is also the voluntary overcollateralization demanded by the market and the rating agencies. Total overcollateralization is, as we see it, a necessary part of the cover pool which prescribes a minimum size but not a maximum limit in the jurisdictions in question. The complete cover pool including overcollateralization, which must merely not fall below a minimum, is first of all made available to covered bond investors in the event of a bank insolvency. To ensure conformity with the national covered bond laws, we think that this claim will also need to be secured in the EU Directive.

SINGLE RESOLUTION MECHANISM (SRM)

Another highly controversial element is the call for a Single Resolution Mechanism (SRM) as part of the banking union. The EU Commission is planning to issue a proposal to that effect in summer 2013. The SRM is due to be created as part of a proposal. The interplay between the Directive establishing a framework for the recovery and resolution of credit institutions and investment firm (RRD) and the central resolution agency is likely to become an exciting issue. With regard to the legal terms, structure, financing and framework for the implementation of the SRM there are at present considerable differences of opinion at the political level. A harmonized and central approach in the resolution of banks is difficult to imagine if the insolvency law bears, at the same, strong national characteristics. The close connection between cover bond legislation and the relevant insolvency law would be immediately affected by this. The insolvency-proof status of covered bonds in the wake of a bank insolvency depends decisively on how these provisions are intermeshed. In addition, the steps to be taken in the event of insufficient assets in the cover pool to service the maturing covered bonds are also determined nationally. Here there are at times considerable national differences that are based on country-specific legal systems. A central intervention in this system is almost akin to squaring the circle and would, in turn, have to take into account this variety of special national characteristics.

LIIKANEN REPORT (RING-FENCING)

Let us now turn to the Liikanen Report. What does an ideal bank look like? Although the working party headed by ECB Council Member Erkki Liikanen concluded that no specific banking business model got through the financial crisis either particularly well or particularly badly, the working party has suggested separating especially risky banking transactions from the remaining activities. This is designed to facilitate a potential resolution of a sub-area in an emergency. This relates particularly to proprietary trading in securities and derivatives. The key demand was for a legal separation of the previously predominant universal bank into a deposit or retail bank and an investment bank. The customer-related business would be located within the deposit bank. Both parts have to refinance themselves independently, cross-subsidization will no longer be possible. Regarding refinancing, Liikanen demands that a bank must have sufficient bail-in-eligible funding, calling for 10% of liabilities. This is based on the idea, in particular, of preventing excessive asset encumbrance. Customers are behind real estate financing and behind the financing of public-sector projects. This should make it clear that the deposit bank can use the funding tool of covered bonds while the investment bank is unlikely to be able to do so. It remains to be seen in which form the deposit bank as issuer will use the price advantage of refinancing via covered bonds, impose higher margins or pass on the advantage to its customers. Since Liikanen, too, works with size-dependent limits so that only the major market participants need submit to the dual banking system, a further separation of the banking landscape into "ring-fenced banks" and the rest would take place. Both newly installed units would then have to meet all provisions pursuant to CRR/CRD IV independently and be subject to national supervision or supervision by the ECB, depending on their size.

CONCLUSION

From today's perspective the interaction between, and cumulative effects of, all regulatory consequences at EU level are almost impossible to estimate. The operational implementation of the individual steps requires highly transparent and efficient rules of cooperation and communication between the individual parties. Decision-making channels must be clear and fast. The additional organizational effort for a functioning network with centralized and decentralized tasks is likely to push transaction costs up substantially. These costs, along with the levies to be paid for financing the supervisor, will ultimately have to be borne by the institutions, and thus the pressure on margins is likely to intensify further. Moreover, it is to be expected that the planned resolution regime of the banking union will increase the funding costs for banks. The bail-in debate, in particular, should lead to a rise in the risk premium for senior unsecured bonds. This means that for the banks the cost-oriented optimization of the liabilities side while observing the attractiveness for investors will move into focus, which in turn will benefit the covered bond. The standard approach across Europe that some are aiming for in the event of a bank resolution should, in the case of covered bonds, in a setting of very heterogeneous national legal frameworks, encounter practical difficulties in its implementation. It would be counterproductive to cause uncertainty with regard to this asset class among investors, as it constitutes one of the most important pillars in the refinancing of banks. Liikanen, too, has stressed the great importance of covered bonds as a refinancing tool.

1.8 LAST EXIT PASS-THROUGH? REDEFINING TIMELINESS

By Florian Hillenbrand, UniCredit, and Franz Rudolf, UniCredit

Covered Bonds – "plain vanilla secured funding", that's what one of the trademark labels has been so far. And indeed, simplicity and homogeneity are some of the cornerstones of success. However, the reverse side of the coin of an ever-growing market (with respect to countries in which covered bonds are issued) is a growing heterogeneity. Although we are still able to attribute the countless covered bond systems to a relatively low number of covered bond models, the variety with regard to collateral types but also structural features is increasing. One of the structural aspects that has shown an evolution that has not yet come to an end is the question of how the redemption payment is organized. In the past, a hard bullet redemption payment promise was undisputed. However, this changed when, due to various sources of pressure and also due to structural creativity, a more relaxed payment promise came into fashion: soft-bullet was the buzz-word. The do or die promise of hard-bullet was diluted to a "do-or do later" promise. In the meantime, a 12-month deferral period has become standard for publically placed paper. However, we already indicated that the evolution has not yet come to an end. In various countries, we hear a discussion about pass-through redemption payments: under certain circumstances, the redemption payment is due bit by bit as liquidity is dripping in. In the following, we will discuss the reasons for this development and will also look at how the market assesses these varieties so far. Due to the low number of observations – in particular in the pass-through sector, a complete and statistically robust analysis is not yet possible. However, our goal is to collect thoughts, find comparables and arrange ideas to quantify the effect of the different redemption formats.

The crisis taught us quite a number of lessons. Most of them meant some negative experiences. However, one particular lesson was actually positive: massively troubled issuers could start lowering their overcollateralization (OC) with the aim to use OC for fresh funding and award a lower or no priority to the goal of maximizing covered bond ratings. This expectation was not just based on a solid gut feeling but also was due to several rating agencies' methodologies. Usually, voluntary OC (OC beyond the legal or a committed minimum level) is no longer recognized by the agencies once the issuer's senior unsecured credit assessment falls below some threshold level. To make a long story short: common sense and rating agencies' methodologies did not survive the reality test: at least so far, each and every troubled issuer kept on working to win the best covered bond rating achievable. However, what was the best achievable rating has deteriorated as the issuer ratings headed down more and more despite the use of more and more OC in committed or uncommitted form. Irrespective of the current financial shape of the issuer, the problem of rating constraints that can no longer be remedied by higher OC is also arising when using unorthodox cover assets. Consequently, the challenge to achieve top-notch ratings had to be tackled by way of structural measures.

In this context, a tool gained in importance that until then was used mainly by UK covered bonds: aiming to mitigate liquidity risk in the aftermath of issuer insolvency, UK issuers were the first to change the repayment plan from a fixed date (hard bullet) to a fixed date with the possibility of extension if certain requirements are fulfilled (soft bullet). The usual tenor for the extension was and still is 12 months.

In particular during the crisis, fostered by market reality as well as by rating agencies (which increasingly emphasized liquidity risk), the rating stabilizing factor of soft bullets materialized more and more. Numerous programs were structured particularly for ECB open market operations with partially ridiculously long soft bullet tenors (80 years and more). Effectively, the step from ridiculously long soft bullet tenors to a pass-through payment structure is negligible: in the former situation, a bond is in default if the redemption payment is not done during the period between expected and legal final maturity, whereas in the latter case a legal final maturity is effectively not defined. In other words, accrued payments from the cover pool are passed through to investors without taking any scheduled repayment dates into consideration. If the term between scheduled and legal final maturity is long enough, the difference versus pass-through vanishes and at the same time liquidity risk is not just mitigated but completely eliminated – consequently, the rating stabilizing effect is maximized. Rating agencies explicitly consider liquidity risk as the greatest source for covered pool losses in the post-insolvency of an issuer. Hence, a repayment schedule like pass-through not only eliminates liquidity risk completely, but also addresses the largest source for cover pools losses globally.

From an investor's point of view, the result from a change from hard bullet to soft bullet and further on to pass-through is that, while investors still have a precise idea of when redemption will take place in hard and soft bullet structures, this is no longer the case in the pass-through approach.

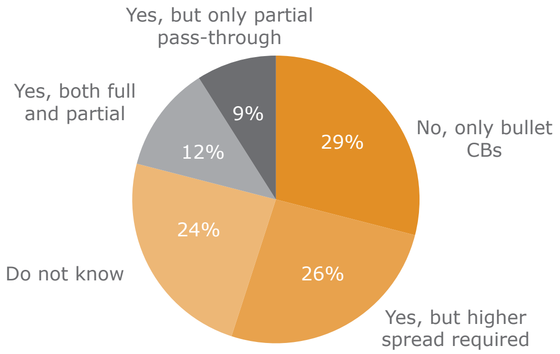
From an issuer's ALM manager's point of view, pass-through structures have the advantage of not forcing the cover pool administrator to sell parts of the cover pool in a stressed environment within a short period of time with significant haircuts on the value in order to accomplish the necessary liquidity to pay back maturing covered bonds. Instead of being forced to sell assets, the cover pool administrator gains time to sell assets in an orderly manner or rely on maturing assets, among other tools. Many hard-bullet issues mitigate this liquidation stress by building-up liquidity buffers either by law or by documentation (incurring costs in the process), soft-bullet and pass-through approaches place this burden on investors.

Already at the beginning of this article, we mentioned that changing the redemption modalities from fixed dates to more flexible ones is interesting for conventional covered bonds of troubled issuers, but also and maybe even more so for issuers trying to set up secured bank funding programs backed by unorthodox asset types. A key moment in this respect was the structured SME backed bank bond issued by Commerzbank in February 2013. Issued bonds based on this particular program transform from a bullet redemption to a pass-through structure following issuer default. It was the first ever secured bank bond with a pass-through redemption structure that was publicly placed in the euro bond market.

HOW DO INVESTORS REACT TO THE DEVELOPMENT AWAY FROM BULLET STRUCTURES?

In an investor survey conducted end-2012, Fitch asked investors if they would buy pass-through covered bonds. The result showed that 29% would only buy bullet covered bonds, 24% have not drawn a conclusion yet, while the rest would be willing to buy pass-through structures, but with certain constraints. 26% thereof would buy pass-through covered bonds only if they receive a higher spread compared to bullet covered bonds. 9% of investors would only buy partial pass-through structures, i.e. with the redemption format of only the covered bond due being changed, but not all covered bonds of the issuer immediately with the insolvency of the issuer. The remainder, 12%, would be willing to buy both full or partial pass-through structures. The outcome at year-end 2012 was unchanged compared to the same survey a year earlier.

> FIGURE 1: HOW INVESTORS REACT TO PASS-THROUGH REDEMPTIONS



Source: UniCredit Covered Bond Research, Fitch Ratings

In fact, it is quite interesting to read about the 26% ratio of all investors that would buy pass-throughs if the spread was significantly higher than in case of a bullet redemption.

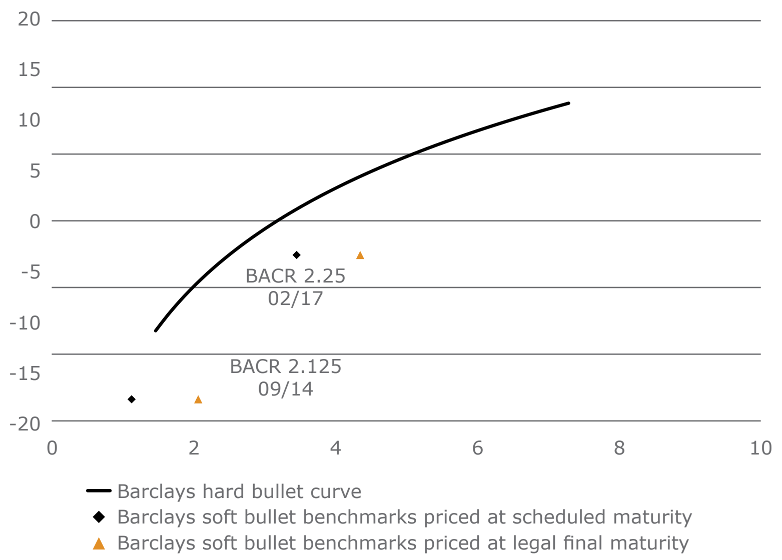
Admittedly, the basis for statistical analysis of trading levels with respect to redemption formats is quite thin. The first source to draw conclusions from is Barclays: the UK's market leader switched its redemption format from hard bullet to soft bullet in 2011, becoming the first issuer in the market to do so. From an analytic point of view, the situation at Barclays is quite convenient: same issuer, same program, same collateral – only difference is the redemption format. Lately, a similar situation also exists in Australia and New Zealand. While the first issues were hard-bullet, the most recent transaction carried a soft-bullet redemption. For simplicity reasons and in order not to repeat ourselves, in the following, we concentrate on Barclays. All descriptions of the situation and all conclusions drawn from the observations are equally valid for issuers down under.

So far, Barclays has two soft bullets outstanding (2014 and 2017 issues), while the other (older) bonds (2015/16/19/21/22) are all hard bullet. A statistical analysis of Barclays' soft bullet and the best fit curve of Barclays' hard bullet bonds reveals that a statistically significant difference in trading levels between these two types of bonds cannot be observed. In fact, the contrary is the case: at the time of analysis, the soft bullet bonds traded slightly tighter (however not significantly). In figure 2 below, we plot the hard bullet curve and plug in the soft bullet bond priced both on the basis of scheduled and legal final redemption. The fact that we do not see a significant spread differential between soft and hard bullets can have two reasons: we could assume that investors simply do not care about this aspect. However, this is in stark contrast to what investors indicate in Fitch's survey, and furthermore, it is in contrast to the concept of homo economicus which is the basis for all reasoning. So we have to argue from a different angle, which means that investors indeed internalize the soft bullet character. So the final pricing of the bond has to be understood as a weighted average price (yield) of the bond redeeming as scheduled and the yield based on a deferred redemption. For simplicity reasons, one might ignore the fact that the stand-alone cover pool administrator is entitled to redeem the bond during the soft-bullet period whenever he is sufficiently equipped and instead apply a digital payment pattern. The equal trading levels of soft and hard bullets based on the digital payment pattern in combination with the assumption that investors do care about the redemption format only allows one conclusion: the likelihood assigned to Barclays' bonds falling victim to a payment deferral is negligibly small – an assumption that does not appear to be wild guess given the A2 senior unsecured rating and the outstanding role it plays not only in the UK banking market. So, much arguing with no real conclusion? Not quite. In fact, the reasoning does not stop at this point: with regard to Barclays' bonds, we talk about a prime issuer with bonds that carry a 1Y soft bullet wording. In other words, the differences between the two types of bonds (soft and hard bullet) are minimized. The credit quality of the issuer is too high and the term of the payment deferral are too short to let a difference in trading levels materialize. Any deviation from this situation - deterioration of the issuer credit quality or term of payment deferral quite quickly and quite sharply triggers a trading difference.

Lately, however, there appears to be a second "landmark" where this difference has a better chance to materialize. We mean Commerzbank. Back in February 2013, Commerzbank issued its inaugural SME backed bank bond followed by its inaugural public Pfandbrief in June. Unfortunately, the analytical situation at Commerzbank is less convenient than at Barclays. The only thing the two bonds have in common is the issuer. Collateral, program documentation, ratings and redemption formats all differ. The Pfandbriefe issued in June carry a plain vanilla hard bullet repayment schedule.

The SME-backed paper comes with a bullet redemption attached that is changed into a pass-through payment once the guarantor has insufficient funds available.

> Figure 2: Barclays Covered Bond credit curve



Source: UniCredit Covered Bond Research

This actually takes us to the first complication: in the case of Commerzbank's SME backed bonds, two thirds of the portfolio redeem within three months, while another 15% redeem within 3-12 months and another 13% within the subsequent year. Hence, from today's point of view, there is only a limited combination of points in time where the guarantor theoretically is able to run into difficulties, and consequently a limited chance that following a default of Commerzbank, a switch to pass-through would be triggered at all. If so, however, the maximum term is, on the one hand, dependent on the term of the cover assets (maximum duration of assets equals 10 years or 5 years longer than the longest bond). On the other hand, there is a maximum pass-through term defined of seven years. Hence, when comparing the trading levels of the hard-bullet Pfandbrief and the SME backed bank bond, there is uncertainty about both the likelihood of a switch to pass-through as well as about the deferral. The current spread differential of these two bonds is 40 bps and it goes without saying that these 40 bps are to be attributed to the sum of all differences, i.e. legal basis vs. contractual basis (including all second round effects such as risk weighting, etc.), rating (Aa1/-/AAA for the Pfandbrief and Aa2/AA for the SME backed) and also the discussed element of extension risk for the investor. In former analyses, we showed that ceteris paribus, the covered bond rating has only a limited spread impact as long as the ratings are still in a comfortable double-A range. One might expect that the difference between legal and contractual structures is dramatic. In fact, it is noticeable as can be observed when comparing the spreads of the old structured covered bonds (no law) of Banques Populaires (Ticker BPCOV) to the Obligations à l'Habitat (law) of BPCE (Ticker BPCECB). Best fit estimations suggest a fair spread differential of around 10 bps. One might adjust this figure slightly upward to reflect the relatively lower liquidity status and therefore the slightly squeezed spreads of BPCOV vs. BPCECB. However, in total, the two effects (rating and law) at best explain a bit more than half of the 40 bps gap between Commerzbank's public Pfandbriefe and SME backed bonds, leaving the rest to other aspects, with the uncertainty about the payment schedule being one item.

CONCLUSION

From a neutral standpoint, the development away from hard-bullet redemption via soft-bullet to pass-through might so far be net positive for issuers and, at best, neutral for investors. We want to stress the expression "so far", since effectively the entire covered bond market is still bullet. It is apparently convenient for an issuer to move away from hard bullet since the cost aspects in securing this promise can be passed on to investors – again – "so far" with no price impact. Even more, this applies to pass-through. Rating agencies also face a quandary in assessing the credit risk of these structures, since on the one hand they are obliged to assess the risk of "non-compliance with bond covenants". Since timeliness is redefined, rating up-notches are facilitated. However, investors have to take on this type of risk, which from their point of view feels like a default but is in fact not.

However, there is another aspect that makes soft-bullets and even more pass-through structures weigh negatively on the further development of covered bonds: a hard-bullet payment promise does not leave room for too many variations. However, the range of variations increases in soft bullet and even more in pass-through: one might basically see two different types of pass-through: 1. All covered bonds are immediately converted from bullet structure into pass-through structure; or 2. Only in case of not being able to repay the maturing covered bond in full, the redemption format of the respective covered bond is changed into pass-through, while the redemption format of the remaining covered bonds not yet due remains unchanged. To make a long story short, the increasing diversity and complexity is not necessarily in line with the overall mantra of covered bonds of keeping things simple.

1.9 COVERED BOND RATINGS FROM AN ISSUER PERSPECTIVE

By Matthias Melms and Michael Schulz, NORD/LB

As defined by the European Commission (EC), a credit rating represents the assessment of the creditworthiness of an issuer or security by a specialised institution. This assessment is based on research activity and is presented according to a ranking system. Today, the use of ratings has become the focus not only of investors but also for regulators. Many investors have investment guidelines that specify a minimum rating for an issuer or product, while conditions imposed by regulatory authorities also have a major influence. The CRD IV, for instance, refers to the standardised approach under which the credit rating governs the allocation to credit quality steps. Securities with a rating below AA- or Aa3 do not belong to the "Credit Quality Step 1" category and must be stated with a higher risk weighting.

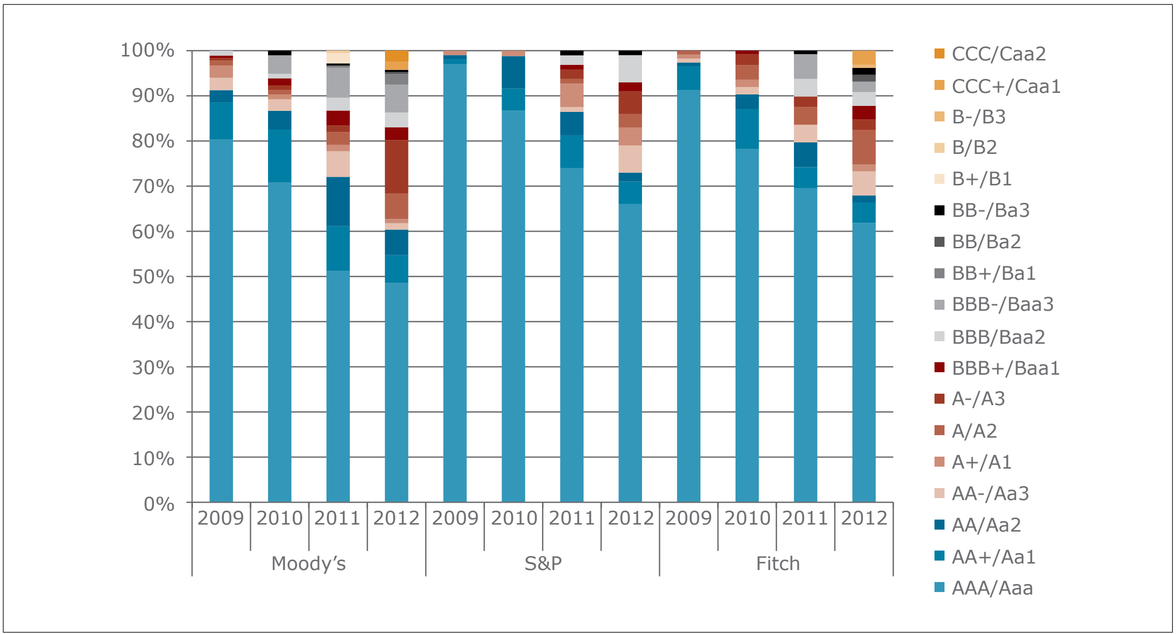
This article initially looks at the relevance of ratings for issuers and investors before moving on to describe how the rating landscape in the covered bond market is changing. The 17-question survey of 66 covered bond issuers on the subject of ratings, which was conducted as part of this article, forms the core of our analysis. The presentation of the results is followed by a discussion and evaluation of the findings, as well as a brief overview of current regulatory efforts.

While it can make sense from an economic perspective for an issuer to forego a notch uplift for cost reasons, for an investor, a downgrade sometimes determines whether a bond remains in the portfolio or not. Against this backdrop, developments in the rating landscape in the past few months have been viewed in part with mixed feelings. At a time when only seven European countries still carry the highest rating from the three credit rating agencies (CRAs), Moody's, S&P and Fitch, and the assignment of a rating is sometimes linked to this very classification, downgrading a rating has a major impact. As a result of the rating methodologies currently used, the "country ceiling" often represents an insurmountable hurdle for covered bond issuers from periphery countries, and in the past has partly triggered cascading downgrades that started with the country rating, moved on to the issuer rating and ultimately affected the covered bond rating. Looking at the terms and conditions for inclusion in indices such as the iBoxx EUR Covered, these only specify an investment grade rating, but even this is no longer the norm today.

THE RATING LANDSCAPE – WHERE HAVE WE COME FROM AND WHERE ARE WE NOW?

Ever since the Lehman collapse and the start of the financial market crisis in 2008 and 2009, the signs for bank and bond ratings have been pointing towards consolidation. This was not due to newly uncovered risks, but rather because of a stronger weighting of existing risk factors by the CRAs. The momentum picked up notably with the outbreak of the sovereign debt crisis not just in Europe but worldwide, and ultimately also affected the ratings of covered bonds. Nowadays, it is essentially no longer a question of a "rates product" or a "credit product". Cascading rating dependencies between countries, issuers and bonds are the reason why the assets affected are caught up in a persistent rating spiral which leads to falling ratings overall. The methodologies of the three big CRAs generally contain a link between the issuer and its covered bonds, which constitutes the main driver for changes in the rating. Furthermore, the fundamental environment has changed dramatically. Driven by weak macroeconomic framework data, the price slide in some real estate markets has had a significant impact and ultimately this has also affected the ratings of covered bonds.

> Figure 1: Rating development over time



Source: Rating agencies, NORD/LB Fixed Income Research

While the share of AAA covered bonds in the programmes rated by Fitch still amounted to 97% at the end of 2007, this had dropped to around 61% by the end of 2012. At the same time, the range of different ratings increased and today the CCC+ segment boasts as many as four classifications. At Moody's, a large number of downgrades of EMEA covered bond programmes led to the proportion of top ratings falling from over 80% to less than 50% between December 2009 and December 2012. In this short timeframe, a sub-market segment also emerged that had been inconceivable at the start of the financial market crisis: non-investment grade covered bonds. At the end of last year, these accounted for 7.5% of the EMEA universe at Moody's and concerned 16 programmes. With regard to the various rating clusters, although Aaa ratings still dominated at that time, 18% of the ratings were in the A segment and 13% of the covered bond programmes had a rating of Aa1 to Aa3. The programmes rated by Standard & Poor's show a similarly strong rating migration over the past four years. At the end of 2006, 99% of the 110 covered bond programmes rated by the agency at the time still had the top rating of AAA. This proportion then visibly reduced in the subsequent years until at the end of December 2012, when only two thirds were still assigned to this quality category. At this point, 8.4% received ratings that were below A-.

A similar trend is evident when looking at the average ratings of the bonds outstanding in the market at the moment. Today, the bonds included in the iBoxx EUR Covered on average no longer carry the aggregate AAA classification. Although 60% of the bonds are still rated AAA, the average classification is lower. Up until a few years ago, the picture was different. For a long time the Index had an average rating of AAA, but this came under growing pressure with the outbreak of the sovereign debt crisis. If you expand the focus to all benchmark bonds currently outstanding with a volume of at least EUR 500m and apply a volume weighting, around 64% of all covered bonds today receive an AAA/Aaa rating from the three major credit rating agencies.

However, when comparing ratings in purely numerical terms, attention must be paid to the composition of the sample. Credit rating agencies value a wide range of programmes in regions that differ significantly from one another at times. The same is true for the evaluation of rating aggregates at index level, as index operators can also apply differing inclusion rules, which make a comparison more difficult. These also include restrictions regarding permitted residual times to maturity, which produce distortion effects with regard to the overall market. Last but not least, incipient market cycles and a survivorship bias ensure a changing rating landscape. For instance, issuers and bonds with poor ratings have disappeared from the market over the past few years, in part through takeovers, and this has influenced the rating landscape.

INVESTOR SURVEY

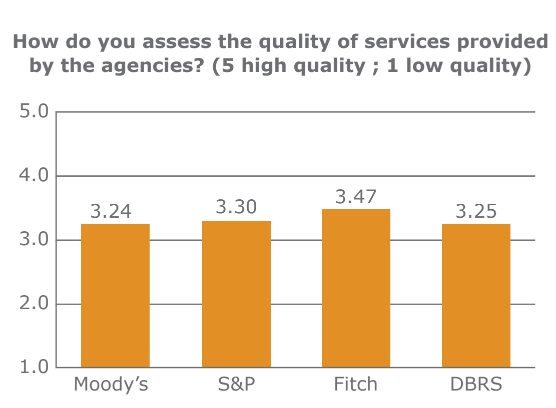
To gauge the opinion of issuers on various issues relating to ratings, we conducted a 17-question survey of European covered bond issuers. Responses were received from 66 banks in a total of 18 countries. Every European country in which there has been at least one benchmark issue (we define this as a publicly placed EUR issue with an issuance volume of at least EUR 500m) in the past was represented. The issuers surveyed have set up a total of 89 programmes, of which 56 are backed by mortgage securities. Public sector claims were used as collateral for the covered bonds in 28 of the programmes. Furthermore, one programme was secured with a mixed pool, and shipping loans and other assets were used as collateral for two programmes each respectively.

Some of the 89 programmes have ratings from more than one credit rating agency and a total of 127 ratings were submitted as a result. Of these, Moody's accounted for 43%, followed by Fitch (28%) and S&P (27%). Three programmes were rated by DBRS, which equates to 2% of all of the responses. The breakdown reflected by the survey therefore almost chimes with the actual distribution for the credit rating agencies across all European covered bonds as at 31 December 2012 (Moody's: 50%, Fitch: 26%, S&P: 23%, DBRS: 1%). The low number of responses for DBRS produces several outliers in the results of the survey. Nevertheless, we have decided to show the results for DBRS as well, in order to achieve a higher level of comparability across all of the agencies represented in the covered bond market. In terms of the number of programmes by the individual issuers rated by the respective credit rating agencies as at 31 December, the participation rate in the issuer survey ranges from one quarter to one third for the individual credit rating agencies (Moody's: 26%, Fitch: 32% and S&P: 34%). On the whole, we therefore consider the results of the survey to be representative and believe that they provide a good overview of sentiment among covered bond issuers.

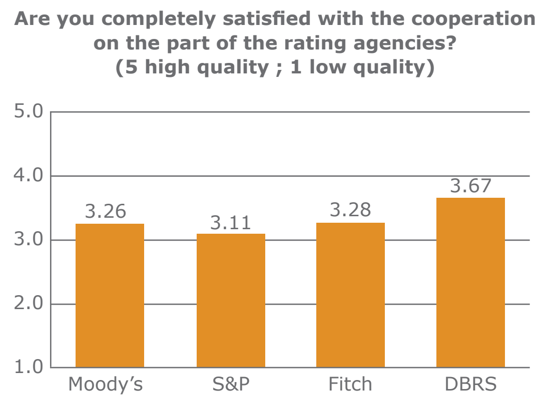
The question of how many ratings a covered bond programme needs to attract investors elicited divergent responses. (Question: How many ratings of different agencies are necessary to attract investors?) While not one issuer believed that ratings were required from three or more agencies, 52% were of the opinion that just one rating is sufficient. Another 46% consider two ratings necessary. One issuer stated that no ratings are required. In our opinion, the fact that no issuer believes that more than two ratings are required also reflects the declining importance of ratings. (Question: Has the importance of ratings changed in recent years?) Although 27% of the banks surveyed believe that the importance of ratings has increased in the past few years, 44% stated that their importance is unchanged. At 29%, almost one third of the institutions consider the importance of ratings to be on the decline.

The marks awarded by the issuers surveyed for the quality of services provided by the credit rating agencies were slightly above average in all of the responses. (Question: How do you assess the quality of services provided by the agencies?) On a rating scale of 1 (low quality) to 5 (high quality), the quality of service is rated in a narrow range of 3.24 points (Moody's), 3.25 points (DBRS), 3.30 points (S&P) to 3.47 points (Fitch). The higher score for Fitch stems from particularly frequent scores of "4" and "5" given in a total of 53% of the responses. By comparison, these high scores were mentioned more rarely for DBRS (50%), Moody's (41%) and S&P (40%). While an average rating was awarded particularly frequently for S&P (43%), the responses for Moody's presented a highly differentiated picture. Here the scores at the ends of the rating scale were particularly pronounced. The lowest mark of "1" (low quality) accounted for 7% of the responses and the highest mark of "5" (high quality) for 10% of the responses.

> Figure 2: Quality of services



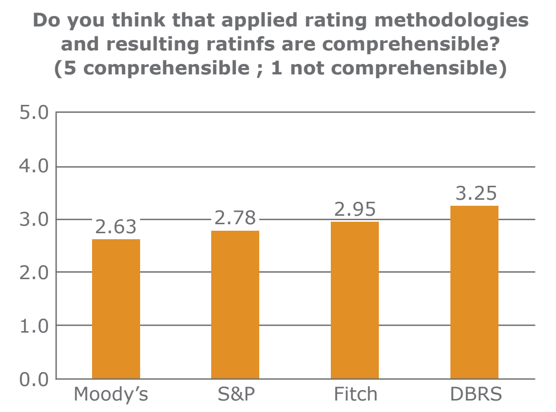
> Figure 3: Cooperation



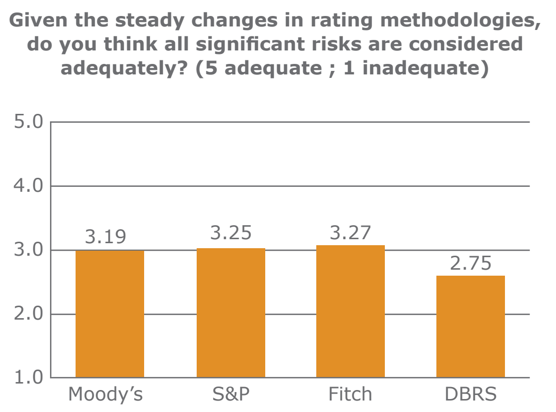
Source: NORD/LB Fixed Income Research

Like the quality of services provided, the cooperation of the credit rating agencies with the issuers also scored a slightly above-average rating. (Question: Are you completely satisfied with the cooperation on the part of the rating agencies? – [5 very satisfied – 1 very dissatisfied]). Next to the narrow range of the scores for S&P (3.11 points), Moody's (3.26 points) and Fitch (3.28 points), the mark for DBRS (3.67 points) stands out. However, it should be taken into consideration here that the number of ratings for the agency (three) distorts the result. The marginally weaker rating for S&P by comparison with the other agencies is due to the proportionally lower number of above-average "4" and "5" scores. The total figure for these two categories for S&P is 37%. In contrast, Moody's received a total of 45% of responses in this segment, with Fitch achieving 42% and DBRS 67%.

> Figure 4:Comprehensibility of methodologies and ratings



> Figure 5: Consideration of significant risks

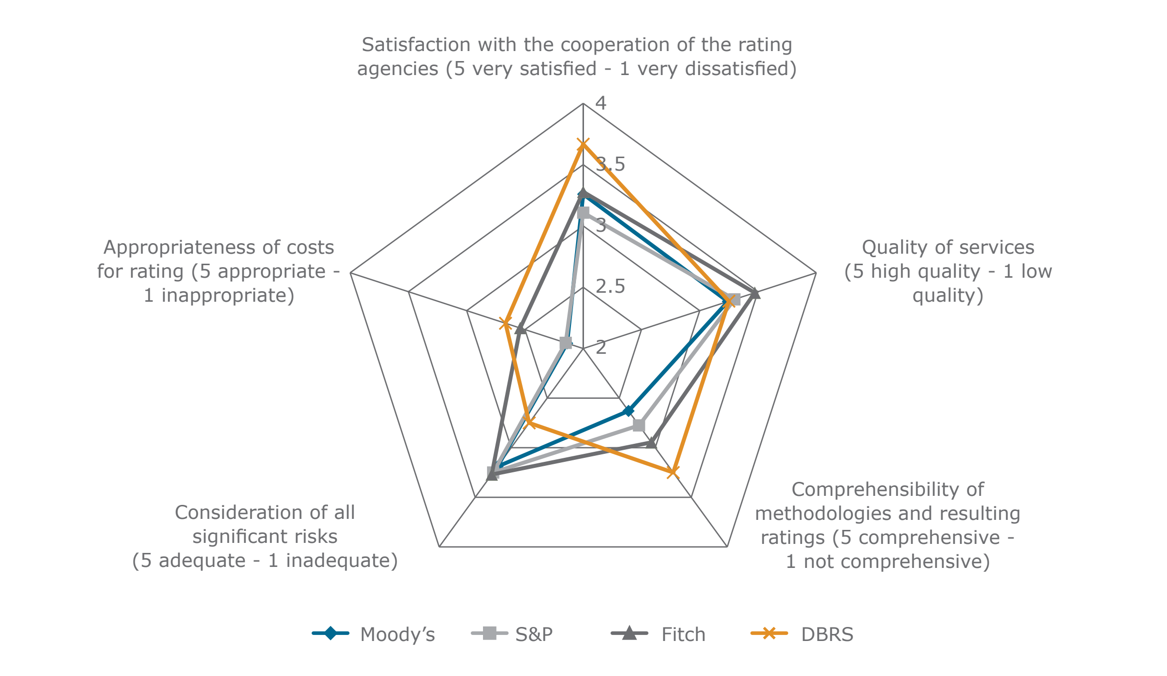


Source: NORD/LB Fixed Income Research

Issuers' responses to the question of the comprehensibility of the rating methodologies and result of the rating analysis are not consistent. (Question: Do you think that applied rating methodologies and resulting ratings are comprehensible? – [5 comprehensible – 1 not comprehensible]). The results are slightly below average for Moody's (2.63 points), S&P (2.78 points) and Fitch (2.95 points), while the score for DBRS is slightly above average at 3.25 points. The comparatively weaker scores for Moody's and S&P are due to the large share of below-average ratings. In total, 45% of the ratings given for Moody's and 43% of those for S&P were the two lowest marks of "1" and "2". In contrast, these accounted for only 25% of the responses for Fitch. Furthermore, almost half of the scores for Fitch were the average rating of "3" (Moody's: 33%, S&P: 30%, DBRS: 75%). With regard to the question of the consideration given to significant risks within the rating methodologies, the picture is, on average, homogenous. (Question: Given the steady changes in rating methodologies, do you think all significant risks are considered adequately? – [5 adequate – 1 inadequate]). With scores of 3.19 points for Moody's, 3.25 points for S&P, 3.28 points for Fitch and 2.75 points for DBRS, the issuers believe significant risks are taken into consideration. However, S&P's score here does not provide a clear picture. With a rating of "4" or "5" awarded by 48% of respondents (Moody's: 39%, Fitch: 38%), the opinion that risks are taken into consideration to an above-average degree is strongly represented. Yet at 26%, the opinion that the ratings methodologies do not adequately consider significant risks (ratings of "1" or "2") is also mentioned more frequently than for Moody's (24%) and Fitch (16%).

An interesting result was delivered by the question "Do you think that the costs for obtaining and maintaining a rating are appropriate? – [5 appropriate – 1 inappropriate])". None of the issuers believed the costs to be appropriate. There were 138 responses to this question. The average of all the scores awarded were significantly below average, with the assessment for Fitch (2.54 points) and DBRS (2.67 points) notably better than for Moody's (2.14 points) and S&P (2.15 points). The classification "inappropriate" was cited particularly frequently for Moody's (28%) and S&P (25%). For Fitch, this rating only accounted for 8% of the responses (DBRS: 0%).

> Figure 6: Interpretation of data concerning the evaluation of rating agencies



Source: NORD/LB Fixed Income Research

The evaluation of the qualitative questions relating to the credit rating agencies shows that Fitch received higher marks in part than Moody's and S&P. This is particularly true for the question of whether costs are appropriate (Fitch: 2.54 points, Moody's: 2.14 points, S&P: 2.15 points). On other questions, the gap between the credit rating agencies is often negligible. However, it should be taken into account here that the participation rate in relation to all of the programmes rated by an agency was between one quarter and one third (26% Moody's, 32% Fitch and 34% S&P). The actual assessment of the credit rating agencies by all of the issuers for which a programme is rated may therefore deviate from the results of this survey.

In all of the rating approaches, there is a link between the issuer rating and covered bond rating. This essentially very close link is only rarely broken, giving rise when it occurs to a valuation carried out that is decoupled from the issuer rating. This generally happens if the structure of a programme (e.g. pass-through) means it can be rated without reference to the issuer (Question: In your opinion, is it appropriate to link a covered bond rating to the issuer's default rating?) While a total of 74% of the issuers surveyed judged this approach to be appropriate, the picture among French and German issuers in particular was more differentiated. In France, five out of thirteen issuers ranked the approach as inappropriate, as did six of twelve issuers in Germany. In recent years, the credit rating agencies have instituted a raft of changes in their rules in order to incorporate identified risks more precisely into their methodologies. These changes generally had a concrete impact on the rating of covered bond programmes. To give issuers the opportunity to react to the new requirements and adjust their programme structures, the agencies normally allow a transition period before the new rules come into force. (Question: Usually there is a transition period following changes in methodologies enabling issuers to adapt to the new requirements. Do you consider the duration of transition periods in general as sufficient?) Although 62% of the survey participants believe that the period is long enough to carry out the necessary adjustments, at 38%, more than one third of the issuers surveyed were of the opinion that the timeframes in the past were insufficient. The increase in rating changes is generally also associated with stricter requirements for the banks responsible for the programmes. These range from the provision of information through to procedure changes in order to comply with the agencies' conditions. (Question: Have requirements of credit rating agencies changed over recent years?) At 92%, the clear majority of survey participants believed this to be the case. Only 8% were of the opinion that the requirements had not changed. In contrast, not one issuer believed that the requirements had eased.

The increase in rating migrations over the past few years has made it necessary for issuers to deal with the topic of downgrades. (Question: Do you have a covered bond rating threshold?) Of the banks surveyed, 68% had defined a rating threshold that should not be breached. While one third of the issuers have defined a floor of AAA/Aaa for themselves, the proportion of institutions with a self-defined minimum rating of AA/Aa stands at 21%. For a further 8%, the threshold is A/A and 6% of the issuers have defined a rating of less than A as their floor. A further 32% of the institutions stated that they had not defined any rating threshold. However, it should be taken into account here that many issuers have only a marginal influence on their covered bond rating. This is particularly the case if a country ceiling caps the rating of the covered bond programme and it is therefore not possible to exploit the rating potential of a programme in full. Moreover, a weaker sovereign rating also has an indirect impact on the assessment of the covered bond programme via the issuer rating. This explains why it is particularly those banks that have their registered office in a country with a minimum rating of AA/Aa from the credit rating agencies that do not cite a rating threshold or have defined a minimum rating of AA/Aa. Conversely, issuers from countries with a sovereign rating of A or lower have either defined a rating threshold of (i) A, (ii) lower or (iii) set no minimum rating.

Along with the question of a rating threshold is the matter of the costs required to maintain a certain rating level. (Question: Given the higher funding costs of overcollateralisation (OC), how much additional OC would you be willing to provide for an uplift of one further notch?) Costs in this regard mean the provision of overcollateralisation to meet a credit rating agency's requirements for a specific rating level. The response from the issuers was far from unequivocal. While 18% of respondents did not want to provide additional overcollateralisation to reach a specific rating level, 20% are prepared to provide overcollateralisation of an additional 2.5% to maintain or reach a particular rating. A further 22% would provide 5% additional overcollateralisation. Around a quarter, or 24%, of the survey participants state that they would defend a rating threshold regardless of the additional costs involved in the form of additional overcollateralisation. On the whole, issuers see the link between the rating and spread changes as tending to decrease (Question: Has the link between a covered bond rating and its spread changed during 2012?) While 13% see a growing link between the rating and the spread, 53% of the respondents consider that the correlation declined in 2012. Of the banks, 34% see the link as unchanged.

The question of tighter regulation of credit rating agencies was the subject of wide debate during the financial crisis. (Question: Do you appreciate the fact that rating agencies are faced with increasing regulation?) The majority of the issuers surveyed would welcome stricter regulation of credit rating agencies. This was the response from a total of 80% of the survey participants. Only 8% stated that this was not necessary. A further 12% have not yet formed any opinion on this. Although strict regulation of the credit rating agencies is welcomed, at 52%, only a slim majority of the issuers surveyed were of the opinion that an "EU rating agency" would be desirable (Question: In your opinion, would a newly built EU authority which serves as rating agency be beneficial/desirable?) Even so, at 34%, one third of the respondents rejected an "EU rating agency", while 14% were as yet undecided.

THE REGULATORS VIEW

Total confidence in ratings disappeared with the Lehman collapse at the latest. Today, the ratings issued by the CRAs are scrutinised in many respects, which ultimately also brought the regulatory authorities into the arena. In addition to the registration obligation for credit rating agencies that has already been introduced, the EC, for instance, is presently considering further regulatory intervention. The EC identified the sovereign default rating as the mainstay of many decisions. The rating cascade described at the start of this article means that all institutions reliant on operations in their home country can be affected by a downgrade in the country rating. Moreover, criticism also centres on the timings of rating decision announcements in the past. In the final analysis, these announcements were rarely too early from an investor perspective, and generally seen as too late. In this regard, the EC did not like the apparent "salami tactics" employed, which in the case of Greece led to an endless run of downgrades.

The EU Regulation on Credit Rating Agencies, which came into force in December 2012 and includes the establishment of a European regulatory body, the European Securities and Markets Authority (ESMA) contains three core elements: (i) registered agencies must comply with extensive requirements, including assuring a high quality rating as well as an independent and comprehensible rating process; (ii) avoiding conflicts of interest among the participants involved in the rating process; (iii) the ESMA has extensive rights to supervise credit rating agencies. This also encompasses inspecting documents and summoning and hearing persons, as well as imposing sanctions and penalties. Even though the use of ratings is regulated, for instance in the CRD, there is at present no regulation covering the maximum influence of credit ratings.

The recently initiated regulation efforts regarding CRAs and credit ratings are set to reduce the reliance on external ratings. One of the ways this is to be achieved is by using internal valuation procedures. In a second step, references to external ratings are largely to be removed where possible. Four facts are cited as justification for the need for additional regulation: (i) downgrades of sovereign ratings have a direct impact on a large number of market players but are usually non-transparent; (ii) investors rely very heavily on ratings but usually only have limited access to the information required to form their own opinion; (iii) conflicts of interest at times cannot be ruled out since a credit rating agency receives a fee for the creditworthiness assessment; (iv) CRAs bear only inadequate liability for investor losses that have arisen as a result of rating decisions.

The EC cites the reduction of conflicts of interest as its central goal. This is to be achieved by limiting voting rights in and of credit rating agencies, the engagement of at least two agencies for structured products, the introduction of a rotation system (every 4 years) for complex products and the inclusion of smaller credit rating agencies. Moreover, all ratings are to be published on a European rating platform to increase transparency. There are also plans to increase the information deadline for all issuers from 12 hours to one full working day. This would give those affected more time to review the expected rating change. In contrast, (apart from defined exceptions) it will only be possible to change the rating of EU states three times per year. This would be in line with a calendar to be published in December of the previous year, and would therefore mean that market players would be able to "have confidence in" relatively stable ratings.

In recent years, rating migration on various financial instruments has led to a discussion about the role of the credit rating agencies, which at political level has prompted a comprehensive reassessment of the credit rating agencies. At the moment, a large number of proposals to increase the regulation of credit rating agencies are being discussed. In addition to tools to increase the level of supervision, these include measures to strengthen competition. However, we conducted the survey presented here in order to add an opinion from covered bond issuers to the debate as well. While some results were in line with our expectations, other statements were indeed surprising. We would therefore welcome other market players also using these findings to stimulate a wide-ranging debate.

1.10 LONG-TERM FINANCE, LONG-TERM FUNDING AND THE ROLE OF COVERED BONDS

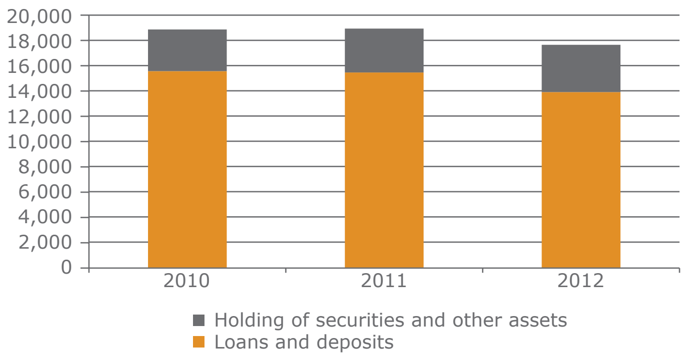
By Michael Schulz, NORD/LB

The banking sector plays a pivotal role in long-term financing and long-term funding. There is, however, no standard definition of "long-term", and the concept can therefore encompass different maturities. In literal terms, long-term means "lasting or valid for a long time". In the ECB monthly statistics, long-term refers to securities with a maturity of more than one year, with optional maturities where the minimum is longer than one year, as well as securities with no specific maturity. In contrast, when textbooks refer to long-term finance they generally consider maturities of more than four years as 'long-term'. As regards the use of 'long-term' in the capital market, this expression most commonly refers to maturities of over five years and, in some cases, of over seven years.

Banks act as intermediaries for the journey from capital investment to loan, offer both investment products for different market players such as savers, and provide liquidity to consumers, companies and public sector bodies. But alongside their function as lenders, banks also act as intermediaries for capital market products. In addition to their own funding, they are available for equity and debt capital transactions and via their distribution channels they create direct or indirect access to the capital market. For instance, bank loans do not necessarily remain on the banks' balance sheets until they mature and some are transferred to the capital market through reselling or as collateral through securitisation (ABS, CLN etc.). A corporate loan can thus become a tradable investment instrument. In Europe, at 85%, by far the lion's share of the demand for financing is fulfilled through on-balance bank lending. Moreover, banks play the part of maturity and risk transformer by offering capital market products such as derivatives, futures and options, and transform maturities with the aid of their balance sheet structure. This not only avoids the problem of adverse selection, but also means that the needs of the various market players can be better met. However, in addition to banks, other market players act as links between financial investments and raising capital. These include, for example, investment companies, insurance companies and pension funds. Today these investor groups are among the biggest players in the capital market besides the banking sector.

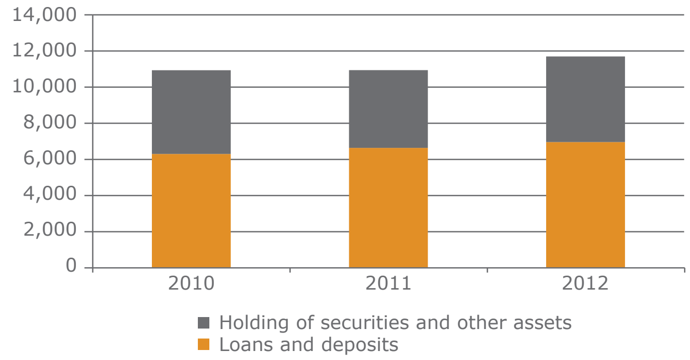
This article examines the towering importance of the financial sector for long-term finance and long-term funding of the European economy. Covered bonds are a key product here and can be used to satisfy the needs of all parties. In the course of this article we also look at the EU Commission's Green Paper on "Long-term financing of the European economy", which focuses inter alia on the provision of sufficient capital for companies and major projects in the future as well as the potential harmonisation of covered bond rules.

> Figure 1: Claims on banks



Source: BIS, NORD/LB Fixed Income Research

> FIGURE 2: CLAIMS ON NON-BANKS



Source: BIS, NORD/LB Fixed Income Research

Interest rates remain low in the global financial and capital markets due to political and economic reasons. The situation is once again strained, which means that important financing channels are at times only available to a restricted extent. Stricter regulations on capital requirements for lending by banks coupled with limited capital resources are constraining the business opportunities of financial institutions and causing them to adopt a more restrictive approach to lending. In this environment, it is particularly important for companies and infrastructure projects to obtain long-term finance. The questions in the "Bank Lending Survey" carried out on a quarterly basis by the ECB relate precisely to the lending behaviour of banks in the Eurozone. This has become more restrictive which, among other consequences, led to a negative result in the ECB survey conducted in April 2013. As the figures for the first quarter of 2013 show, ultimately credit standards have tightened further although the momentum has slowed somewhat. Companies in the Eurozone faced stricter net credit standards, although the increase was slightly less, dropping from 13% to 7%. Companies are therefore still struggling with the growing difficulty of accessing capital via banks. Credit standards for real estate loans and consumer loans have also tightened again. While the net tightening for housing loans dropped only marginally from 18% to 14%, the momentum for consumer loans fell quarter-on-quarter from 9% to 7%. The main driver for the renewed tightening of credit standards was the reduced willingness of banks to grant risk capital as well as higher funding costs and balance sheet constraints.

FINANCING SEGMENTS AND THE ROLE OF COVERED BONDS IN DIFFERENT JURISDICTIONS

Whether short, medium or long-term loans, banks play a key role in the international finance market. In line with their business model, this results in various levels of net interest income which, depending on the type of credit, can lead to higher write-downs. However, the classification of differing forms of finance according to the concept of short, medium and long-term maturities is difficult. Some types of loan occur in all three maturities, while others can be allocated to just one or two maturity bands. There are differences between loans to consumers such as uncommitted instalment loans, car loans and student loans, as well as loans to public sector bodies, SMEs and export finance. Credit card receivables also come under claims on consumers but are to be viewed on a differentiated basis. Finance for aircraft, renewable energy, infrastructure projects, mortgages and shipping is generally long-term finance.

With regard to funding opportunities using covered bonds, specific criteria enshrined in dedicated legislation traditionally regulate the eligibility of cover assets. In the following however, this article looks briefly at the claim characteristics of specialised finance such as aircraft and shipping finance, consumer finance, corporate finance, export finance, green energy and other project finance activities, real estate finance and public sector finance. The ECBC Covered Bond Label provides some useful guidance in this context.

SPECIALISED FINANCE SUCH AS AIRCRAFT AND SHIPPING FINANCE

The financing of aircraft and ships counts as specialised finance and, in terms of the banks operating in these areas and the volume of loans taken out, comprises a niche segment of the finance market. The maturity spectrum generally comprises long-term financing agreements, but these are usually denominated in US dollars and feature special redemption rights. It is because of this that aircraft and shipping finance cannot be allocated to long-term finance on an unqualified basis. The national economic importance of these transport and logistics objects makes them significant business areas at international level. However, they are also particularly cyclical, and this is presently being felt by the shipping market, especially in the form of a longer-than-expected crisis. This is usually due to surplus capacity in different types of ship that can only be reduced in the medium term. European banks in particular are among the major ship financiers. The demand for finance dropped sharply during the crisis, falling from USD 200bn in 2010 to USD 150bn and USD 55bn in 2011 and 2012 respectively. While there are only relatively few aircraft and ship manufacturers, the number of buyers and operators is large. According to figures from the two largest aircraft manufacturers, Airbus and Boeing, banks only account for around 30% of aircraft financing. While more and more players are pulling out of shipping finance, such as Germany's Commerzbank, the number of banks and direct investors flocking to the aircraft finance market, which is worth around EUR 100bn, is increasing. Low interest rates are attracting financial institutions, funds and pension funds, as well as insurance companies. Although airlines are adversely affected by disasters and economic crises directly in the form of declining passenger numbers, the sector is still very attractive for investors, especially as air traffic has increased by two thirds since 2000. Sovereign funds from China, Singapore and the United Arab Emirates are already involved in the sector with substantial investments and financial institutions from China and Japan are advancing as well.

Today, specialised finance such as shipping and aircraft financing makes up only a tiny proportion of the cover pools for covered bonds. This form of financing only occurs in the legislation of a few countries, including Denmark, Greece, Luxembourg and Germany. Consequently, the volume of these types of covered bond (in pure form) is very low. In Germany, the volume of ship Pfandbriefe stands at around EUR 7bn, while the volume of outstanding publicly placed bonds in the fledgling aircraft Pfandbrief market (debut issue in summer 2012) currently amounts to only EUR 506m.

CONSUMER FINANCE

Consumer loans play a major role in retail customer business. Universal banks and some specialised banks provide their customers with loans that are used for consumption purposes, and can generally be repaid in instalments. However, as a rule these are short and medium-term loans with maturities of up to six years. Although the maturity of the claims is short and loan sizes are small in most cases, the overall volume reached is very high.

Large consumer loan portfolios were an important driver of the securitisation industry as car loans and leasing receivables are used as collateral for asset backed securities. Regarding covered bond funding, it is true that in May 2009, for example, Korea's Kookmin Bank issued a covered bond that was partially backed by credit card receivables. Similarly, the most recently published versions of the legislation being prepared for US covered bonds provide for the inclusion of car loans and student loans as cover assets, though without any certainty about the final outcome. However, from a European covered bond perspective, consumer loans are clearly not eligible as cover assets under the current legal frameworks because they don't comply with the intrinsic criterion for cover asset eligibility which is their suitability to be enforceable as a security over longer maturities. Indeed, non-complex enforceability processes and foreseeability of values and/or performances are important characteristics for cover assets serving as a long term credit security. This approach is also underlying the covered bond definition provided by the ECBC Covered Bond Label.

CORPORATE FINANCE (CORPORATE AND SME LOANS)

While large, renowned companies in particular have a high public profile and generally also trade as joint stock companies, in many countries a major portion of the gross domestic product is generated by small and medium-sized companies (SMEs). In the past, most capital goods were financed via banks, but today this channel has in part been replaced or supplemented by direct transactions in the capital market. Many of these SMEs were hard hit by the financial market crisis, which was usually reflected in restricted access to financial resources. According to statements by some of those affected, the situation meanwhile became a credit crunch, which was triggered by tougher credit standards and a lower lending capacity.

As the results of the ECB's Bank Lending Survey shows, the size of the company is an important factor when it comes to the tightening of credit standards. The easing in the tightening of net lending to small and medium-sized companies in the eurozone in the first quarter of 2013 (from 12% to 7%) is considerably lower than for the large companies (from 15% to 4%). This applied to both short-term and long-term finance, whereby the net tightening in credit standards for long-term finance for SMEs only dropped from 15% to 11%. Large companies have been independently active in the capital markets for equity and debt capital for a long time. They have the necessary resources to issue large-volume corporate bonds and can thus achieve more favourable financing terms than on a bank loan. The market for bonds from SMEs, however, is relatively new and small in terms of outstanding volume. The disadvantages compared to large-volume corporate bonds go beyond the issuance volume, which generally does not even reach EUR 500m. The frequent lack of a rating and their absence from recognised indices due to the two above-mentioned characteristics mean they often hold little appeal for institutional investors. The sustained period of low interest rates in particular acted as a type of catalyst. In the search for a return, market segments therefore evolved for SME bonds, which at times enjoy strong demand.

The utilisation of SME loans in covered bonds is not presently permitted in the legislation of any country with a long tradition of covered bonds. Only a few countries, of which Turkey is one, offer this option. Turkey's Denizbank issued an SME covered bond at the start of 2013 and at the same time opened the door for further issuers in the country. In February 2013, Commerzbank became the first German institution to use SME loans to develop an additional funding opportunity by setting up a structured covered bond programme. While Commerzbank moved outside the legal framework, the French central bank announced a rule that could be used to include SME loans as cover funds for EU issues. Under this rule, a financial institution held by private banks would pool the loans and issue covered bonds at the same time , although it is not known at present whether such issues will be covered bonds or senior secured bonds. There are also efforts to implement SME covered bonds in Italy and Spain. Furthermore, Austrian legislators are considering allowing SME loans as cover assets. HSH Nordbank, among others, took a different route. It used SME loans as cover assets, but added a KfW guarantee on top. With the aid of this guarantee, the loans met the requirements of the Pfandbrief Act and were therefore eligible as collateral for public sector Pfandbriefe.

Again, eligibility of SME loans raises the same concerns as consumer loans with respect to enforceability and suitability of the assets as a long term security. Consequently, SME covered bonds are not complying with the definition of the ECBC Covered Bond Label. At present, they are a niche product in the structured covered bond universe.

EXPORT FINANCE

Having been dominated by a far-reaching recession in 2012, slow stabilisation of the European economy is expected in the first half of 2013. Forecasts by the European Commission in May this year indicate that the global economy remains on a prosperous path. GDP growth of 3% is already expected for this year, mainly on the back of the improving growth prospects for the USA. Sustained growth activity can also be seen in the developing countries, although this varies from region to region. One important factor here is the development of imports and exports. According to the IMF, imports worldwide rose by 2.39% in 2012, while exports were up by as much as 2.47%. However, 2013 is set to see a shift in the weightings, and imports could achieve growth of 3.25% with exports attaining just 2.0%. The volume of exported goods and services in the European Union amounted to some EUR 1,448bn in the fourth quarter of 2012. Banks and export credit agencies (ECAs) such as CESCE (Spain), COFACE (France), Hermes (Germany), SACE (Italy), ECGD (UK) and JBIC/NEXI (Japan), in particular play an important role for the players involved. While banks are primarily involved in the financing of production, the export credit agencies often act as guarantors for international trade. The world leading export credit agency, Euler Hermes, for instance, reported a new business volume of around EUR 110bn (incl. state guarantees) in 2012.

Export finance loans with a guarantee from a ECA are eligible as cover assets for covered bonds under the legislation of several countries. In addition to the German Pfandbrief Act, this is also permitted under the French legislation governing obligations foncières (OFs) and under the Covered Bonds Act in the UK. However, this is contingent on a guarantee from an export credit agency being in place. One example here is BNP Paribas in France, which has guaranteed export finance loans in the cover pools for its OFs. With the law promulgated by the Spanish government in Royal Decree 20/2012 on 13 July 2012, Spain also decided to include export credit as cover assets. A new cédulas category was introduced (cédulas internacionalización), which in addition to the existing mortgage (cédulas hipotecarias) and public sector (cédulas territoriales) claims, can also use export finance with guarantees from public sector bodies or development banks as cover assets.

GREEN ENERGY AND OTHER PROJECT FINANCE ACTIVITIES

The European Commission assumes that within the next seven years, more than one trillion euros will be required to extend and modify infrastructure in the European Union. In addition to the areas of energy and telecommunications, this refers especially to the transport sector. Alongside private banks, savings banks and cooperative banks, major investors such as insurance companies and pension funds are also involved in financing in these areas. The credit agreements here tend to fall in the long-term maturity segment and are frequently carried out on a syndicated basis, since the single name credit risk involved with what are often very large-volume loans cannot always be borne by one institution alone. While banks have increasingly curbed their lending activities over the past few years, due in part to higher capital requirements, institutional investors have stepped up their involvement in the financing of green energy projects and other large-scale project finance. The main reason for this is the fall in interest rates, which has often rendered investment in capital market products unattractive.

Project finance is frequently designed in the form of structured finance and is therefore not suitable for the cover pools of covered bonds without additional measures. To date, such loans have only been eligible as cover assets with the aid of public guarantees, and could then be funded using a public sector Pfandbrief, for example. However, there are already ideas for expanding "green finance" in the cover pools of covered bonds, and the possibilities are the subject of lively debate. The first concept papers for a potential green covered bond market have already been drawn up and allow for an extension of the currently familiar cover assets to include renewable energy criteria. A concrete example is provided by the "Green Deal" in the UK, whereby the improved energy efficiency of a property following refurbishment is supposed to bring monetary benefits for the borrower.

However, a future green covered bond would first require the specification of green mortgage constraints. These could comprise, for example, the achievement of a country-specific energy efficiency level which would result in a lower interest rate on the total loan. However, this can only work if the financing bank benefits from a lower risk weighting, so that it can pass on the advantages in the form of lower interest rates. In Germany, consideration is being given to green Pfandbriefe. However, these do not relate to green mortgages but focus on financing for green energy, which could be used as additional real security. However, this would be contingent on the objects that can be used as collateral in the cover pools being listed in a register so that they are clearly allocable. At the moment, however, the plans regarding both the green covered bonds and the green Pfandbrief are merely at the discussion stage.

MORTGAGE FINANCE

In most countries, real estate finance forms the bedrock of long-term finance. In addition to financing for private property, this generally also includes commercial property finance where the volumes involved are normally larger. According to statistics from the European Mortgage Federation (EMF), the volume of residential property finance in the EU27 member states climbed 84% to EUR 6,535bn between December 2001 and the end of 2011. In the number one spot at the end of 2011, with an outstanding finance volume of EUR 1,454bn was the UK, followed by Germany and France with volumes of EUR 1,164bn and EUR 843bn respectively. However, growth in the market in the period 2009 to 2011 has been varied. While the Baltic states faced declines of between 15% and 18%, the outstanding volume in Italy and Cyprus, for example, climbed by 20% and 15% respectively. Lower figures were also reported over the same timeframe in Germany (-6%), Spain (-4%) and the UK (-5%). Affected by house price bubbles in some countries in the EU, prices have recently stabilised again somewhat. Although in some cases, the increase over the past ten years still amounts to +200%, this picture becomes much more relative when adjusted for the generally simultaneous rise in household incomes. One of the reasons for the overall slowdown in growth is the tightening of credit standards, which gained momentum following the property crises in particular. In this context, the demand for real estate finance has declined, as the ECB's Bank Lending Survey testifies. There was a 26% slump in demand for real estate finance in the EU in the first quarter of 2013 as against a decline of 11% in the fourth quarter of 2012. However, the real estate markets in the EU are characterised by at times widely diverging structures. These include not only the credit standards, which often permit the use of a credit guarantee instead of a mortgage, but also different housing structures. In many EU countries the owner-occupied ratio surpasses the 80% mark, but in Germany and the Netherlands for instance only accounts for 43% and 56% respectively.

The significance of covered bonds for real estate finance has risen notably in recent years, in some European jurisdictions real estate funding relies almost entirely on covered bond issuance. According to the EMF, at the end of 2011, the proportion of residential property finance funded by covered bonds stood at 20%. Furthermore, in some countries, residential mortgage-backed securities (RMBS) play a large part in liquidity generation, which means that the relevant share of covered funding is even significantly higher than this. While specialised forms such as SME structured covered bonds, ship covered bonds and aircraft covered bonds only account for a small portion of the total volume outstanding, mortgage covered bonds dominate in the European context. In terms of all real estate finance including commercial property business, mortgage covered bonds with a volume of EUR 1,821bn were outstanding in the EU at the end of 2011.

PUBLIC SECTOR FINANCE

Despite the recently dramatically changed funding environment, through their lending activities financial institutions remain an important source of funding for governments, semi-sovereign bodies and public sector institutions. However, the access of creditors to the capital market and their involvement in it has notably altered. Whereas in the past it was primarily states that acted directly in the capital market, nowadays this group of issuers has been extended to include regions, municipalities and cities. Savings banks, state-owned financial institutions and development banks, among others, make an important contribution to the long-term and short-term financing of municipalities and cities.

The significance ascribed to public sector covered bonds as a funding instrument varies in the different EU27 member states. Only a few years ago, these covered bonds were hugely important in Germany and accounted for most of the outstanding Pfandbrief volume. The volume has dropped so sharply in the past few years that it has fallen below the EUR 300bn mark. Public sector assets are legally eligible as original cover pools or substitute cover in various countries. However, assets that gain a government guarantee or guarantee from a government-related institution or credit insurer can also become eligible as cover assets for public sector bonds. In the past, mortgage loans, SME loans and export finance loans that were not eligible as cover assets were funded using public sector covered bonds (primarily in Germany and France) in this way. Furthermore, Commerzbank is currently considering systematically funding export finance paired with a guarantee through public sector Pfandbriefe.

GREEN PAPER ON "LONG-TERM FINANCING OF THE EUROPEAN ECONOMY"

A "Green Paper" by the European Commission is the first stage of a regulatory framework at EU level. It is used to initially formulate questions from the Commission that are to be answered by relevant market players during a consultation phase. The subsequent "White Paper" has the character of a draft of a regulation that will be binding at EU level. The next stages are adoption by the European decision-making bodies, the Commission and the Council, ahead of transposition into national law. However, several years can elapse between the publication of a Green Paper and any transposition into national law. The Green Paper on the "Long-term financing of the European economy", initiated by the Commission in March 2013, contains 30 questions on various topics. These do not just relate to definition of terms, but also to factors determining the financing and funding environment in the European Union. These include business strategies and product classifications as well as specific questions on funding products such as covered bonds. The aim of the Commission is to investigate and ensure the availability of capital for long-term projects. The focus is on the possibility of leveraging growth potential and thereby ensuring financing, not only for large companies but also for SMEs and infrastructure projects. SMEs are seen as important economic players whose need for finance must be met. The focus also extends to the creation of a permanently functioning capital and credit market within the European Union, including without the participation of the banking sector. Institutional customers such as insurance companies, investment companies and pension funds are named as key participants that should take over the direct financing of long-term investments. One of the ways this is to be achieved is by defining joint standards.

The question regarding potential harmonisation within the various framework guidelines for covered bonds is targeted at the partially high degree of individualisation between the countries and is in keeping with the Commission's efforts to achieve convergence in the rights and obligations of covered bond issuers and investors. These are directed not only at supervisory regulations and joint publication standards, but also at the eligibility of cover assets for covered bonds. However, the call for greater harmonisation may sound simple but faces a range of hurdles in a regulatory environment that has evolved over years and is adapted to national structures. It is not just the fact that nearly every country in the EU meanwhile has its own covered bond legislation, but also that the individual rules within the legislative landscape of the individual country are often so highly widespread and deeply rooted, that mutual convergence harbours major challenges. Another question also relates to the rise in asset encumbrance at European banks, which is already the subject of debate, but is not examined in any further detail in this article.

HOW TO HANDLE HARMONISATION TASKS

Internationally, efforts at harmonisation pose major challenges for the parties involved. In terms of volume, the covered bond market now stands at more than EUR 2.7tn with new countries and issuers joining on a regular basis. Compared with other funding instruments, covered bonds have emerged from the crisis with virtually no fuss and are among the most important funding products in the banking world, ensuring the liquidity of many institutions. Key parameters here are confidence, liquidity and stability. In this context, a cover pool selection that is not restricted to the financing of public sector bodies, real estate and ships would enhance the usability of covered bonds, yet at the same time the share of asset encumbrance would increase. This would simultaneously lead to an easing of the quality definitions required to date by investors versus mainly structured products.

Having taken many years to evolve, harmonising these different covered bond sub-markets with sometimes highly divergent rules would be a very slow process. However, there is already extensive agreement in the European Union with regard to the cover assets that can be used. Receivables relating to aircraft and railways, ABS and RMBS, for instance, represent collateral with low use potential. What the eligible cover assets have in common with them is that they constitute long-term financing in nature and are measurable. However, there are differences in the legal regulations for standardised and comprehensive transparency standards nationwide. Apart from Germany, there are only a few other countries that legally require issuers to publish cover pool data on a regular basis. While voluntary rules in this regard are complied with by issuers in some Scandinavian countries, information is very hard to come by in some other countries. This is precisely what the transparency initiatives of the CBIC and ECBC seek to address and are aimed at a standardised presentation of information on cover pools and issues. The ECBC Covered Bond Label is complemented by a Transparency Template which accelerates – through its transposition into national templates – the convergence of disclosures. However, this is based at a level with many freedoms. Standardisation efforts could also target common measurement definitions (for example LTV, market value), a consistent understanding of special public sector supervision, which is required under UCITS 52 (4) among others, and the uniform assurance of insolvency-proof cover pool management in the event of issuer insolvency. The behaviour of investors in the crisis has demonstrated very strong confidence in covered bonds overall, even greater perhaps than in some individual countries. Here it was precisely the meanwhile high level of fragmentation in the market that ensured parallel functioning funding options. The respective laws are not only different, they are also based on often highly divergent market standards and sub-segments, such as the real estate market for instance. It can therefore be necessary for laws and regulations to vary in some functions in order to take account of these differences. Nevertheless, there are other points which could be harmonised without destroying the individual character of a covered bond market.

CONCLUSION

It became clear in the midst of the financial market crisis, in particular following the Lehman Brothers collapse, that unlimited credit from banks cannot be guaranteed. The huge loss of confidence had led to financial institutions having inadequate access to fresh funds, which simultaneously resulted in reduced lending to market players in the national economy. Access to finance therefore represents an important parameter in an economic context and is a basic requirement for non-cyclical economic growth. Although banks play a pivotal role in financing for long-term projects and companies, it is desirable to have a supply of financing that is independent of the banking sector. The aim here should not only be to gain sustainable players in times of an upswing, but also to maintain the provision of finance, particularly in times of crisis.

Covered bonds played a central part in funding during the crisis. There are very few countries that do not yet feature on the European covered bond map. Belgium joined in 2012, and has already witnessed several issues. The generally clear and transparent structures are features that promote confidence and in some cases result in investors giving preference to this asset class over government bonds. The limited usability of the collateral in the cover pools is the key to this success. While the meanwhile highly fragmented covered bonds may differ in terms of detailed features, they have strict eligibility criteria for assets in common, whereby harmonisation in other sub-areas would bring additional benefits. With their transparency initiatives, the CBIC and ECBC are already working to develop uniform standards, thereby taking a major step forward towards harmonisation. But consideration should also be given to a standardised approach with respect to special public sector supervision and measurement standards. However, because of the sometimes very different basic structures in the respective countries and the evolved covered bond markets, this is only possible in small steps. Nevertheless, in this regard it should not be forgotten that heterogeneous market structures offer advantages for issuers and investors, and therefore 100% harmonisation is not desirable.

1.11 THE ROLE OF COVERED BONDS IN FINANCING THE EUROPEAN LOCAL PUBLIC SECTOR

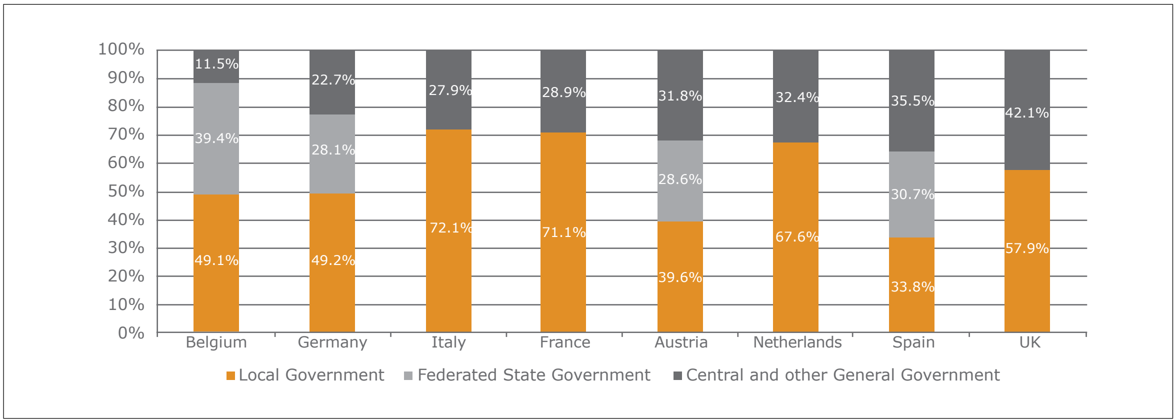
By Ralf Berninger, Caisse Française de Financement Local

THE ECONOMIC IMPORTANCE OF THE LOCAL PUBLIC SECTOR IN EUROPE…

The responsibilities of the different layers of local and regional government are quite different from one country to another. However, in almost all European countries, responsibility for large parts of national infrastructure is in the hands of the local public sector. In 2012 local and regional government accounted on average for only one third of total government spending in the European Union. However, looking only at public sector investments, the contribution of the local public sector goes up to over 70%[1].

Responsibilities of the local public sector generally include at least partial responsibility for the education system and for regional and local infrastructure – key sectors for the economic development in most countries. Budget rules generally prevent local and regional government from running deficits to finance operating expenses. Providing funding to local and regional government therefore almost exclusively finances investments in public infrastructure and education.

> FIGURE 1: LOCAL GOVERNMENT SHARE OF TOTAL PUBLIC SECTOR INVESTMENT IN 2012



Source: Eurostat

… AND ROLE OF COVERED BONDS IN FINANCING PUBLIC SECTOR INFRASTRUCTURE INVESTMENTS

Traditionally, covered bond issuers played a dominant role in financing local and regional government investments in many European countries. However, there is no straightforward relationship between local public sector funding needs and public sector covered bond issuance for a number of reasons:

> Different business models for public sector covered bond issuers exist. In particular, a number of public sector covered bond issuers were not set up as public sector lenders per se, but rather to finance existing export credit portfolios.

> Covered bond issuers are not always able to exactly match the duration between assets and liabilities – in particular for amortizing public sector loans. For this reason, new issuance of public sector covered bonds may be linked to existing assets on the issuers balance sheet and not to new public sector lending

1 Source : Eurostat

(consequently, most of the figures used below refer to the total stock of local authority debt and total outstanding public sector covered bonds and not to annual issuance figures as these may be impacted by one-off effects or by ALM mismatches)

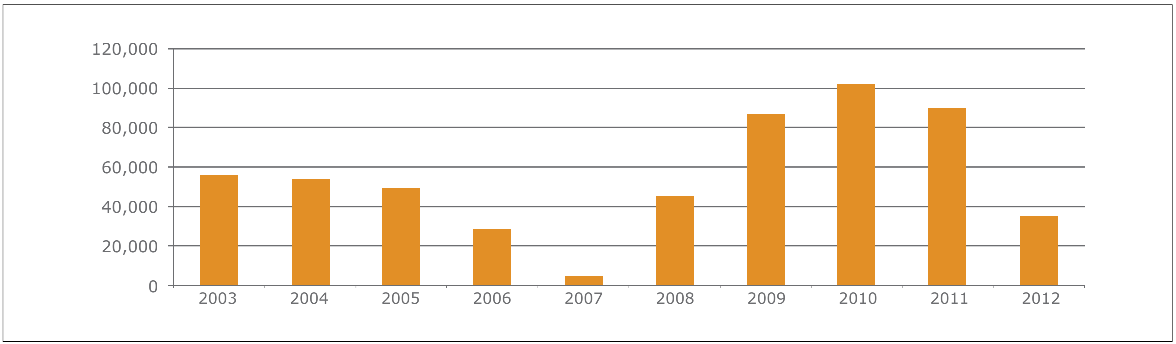
> A number of European countries – for example Sweden, Finland, Denmark or the Netherlands - have created public Agencies which are covering a large part of local government funding needs. Local public sector funding needs in these countries hence will have very little impact on available public sector cover assets

A comparison of local and state government deficit figures to changes in the volume of outstanding covered bonds confirms that there is no apparent link between local public sector deficits and covered bond issuance volumes:

> Looking at debt statistics for the European Union local and regional government, deficits have declined steadily until 2007 followed however by a dramatic increase up to 2010. Over the past two years, deficits have again sharply declined, driven mainly by deficit reduction policies in Germany in 2011 and even sharper deficit reduction rules in Spain in 2012.

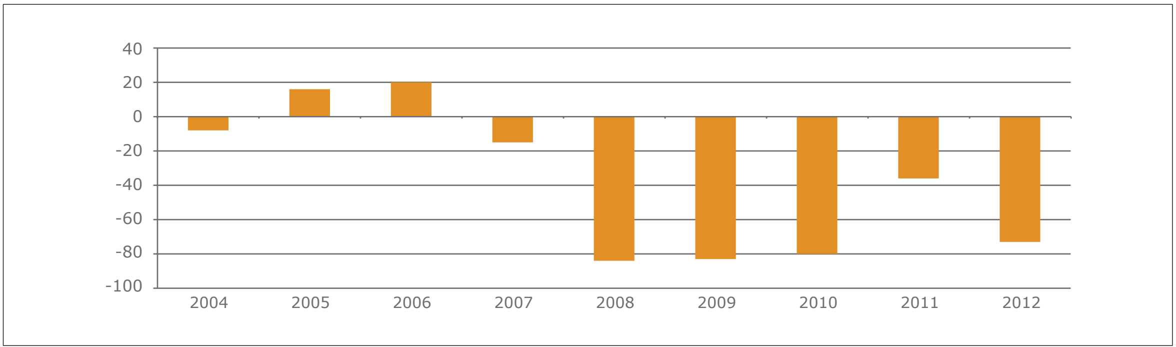
> The outstanding volume of public sector covered bonds on the other hand has increased until 2007, before sharply declining by over EUR 80 bn per year from 2008 to 2010. High levels of Pfandbrief issuance following German re-unification contributed to the high level of redemptions between 2008 and 2010.

> Figure 2: European Union local and federated state government deficit, EUR bn



Source: Eurostat

> Figure 3: Change in outstanding public sector covered bonds, EUR bn



Source: ECBC

However, a closer look at public sector cover pools on a country-by-country rather than on a global basis shows that covered bond issuers do indeed play a key role in financing local and regional government in a number of countries. In particular, a high percentage of local and regional government debt has been financed by public sector covered bond issuers in France, Germany and Austria.

AN IMPORTANT ROLE FOR PUBLIC SECTOR COVERED BONDS IN A NUMBER OF COUNTRIES

The seven major public sector covered bond markets in terms of outstanding volumes are listed in the table below with the total outstanding local and regional government debt listed as comparison at the bottom of the table.

>Figure 4: Outstanding public sector covered bonds and total local and regional government debt 2012 in EUR bn

	Germany	France	Spain	Ireland	Austria	Luxembourg	Italy
Total outstanding public sector covered bonds	301,125	72,033	33,609	27,546	25,831	24,859	10,300
Total local and regional government debt	812,835	174,350	224,464	5,358	27,158	990	131,810

Source: Eurostat, ECBC

Ireland and Luxemburg are exceptions in the sense that a well established public sector covered bond frameworks does exist without matching significant domestic local authority financing needs.

Looking at the other five markets, the importance of covered bond issuers in financing local and regional government investments varies strongly from one country to another:

> Germany: German Länder often have sufficiently large funding needs to directly access the bond market as frequent borrowers. In contrast, a significant part of the funding needs of German municipalities has been financed by covered bond issuers. German public sector cover pools contained EUR 69.9 bn in claims against German municipalities against total municipality debt of EUR 143 bn. In addition to the funding provided to the German public sector, Pfandbrief issuers also hold EUR 24 bn in claims against the local public sector in other European countries.

> France: French Sociétés de Crédit Foncier currently hold EUR 50 bn of claims against French local and regional government in their cover pools, which represents roughly 40% of total French local authority debt.

> Spain: Spanish local and regional government debt represents a large part of total government debt, due to a relatively high degree of decentralization. Even though the outstanding volume of Cédulas Territoriales is significant, the percentage of sub sovereign debt financed via covered bonds is less important than in France and Germany

> Austria: Total public sector cover pools assets stood at EUR 35 bn, 92% of these exposures were to Austrian public sector entities, suggesting that a very high the share of local public sector debt has been refinanced via covered bonds.

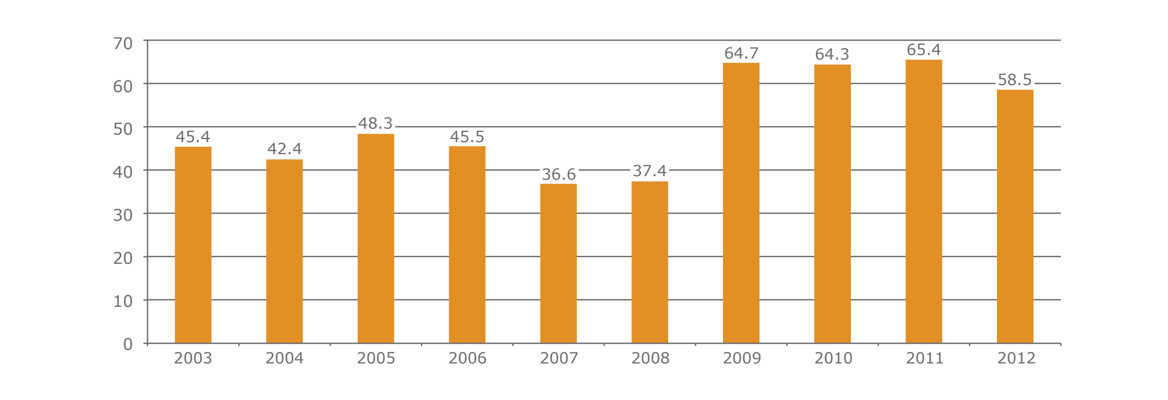
> Italy: Italian public sector covered bonds stood at EUR 13 bn, covering only a small part of Italian sub sovereign debt, with state owned development bank Cassa Depositi e Prestiti covering most of these funding needs.

DIRECT BOND ISSUANCE AS ALTERNATIVE SOURCE OF FUNDS FOR SOME PUBLIC SECTOR ISSUERS

Facing more difficult conditions in the loan market, local authorities have increasingly turned to direct bond issuance as an alternative source of funding. Direct bond issuance by local and regional government stood at EUR 58.5 bn[2] at the end of 2012, (compared to EUR 36.5 bn in public sector covered bond issuance in 2012). However, a more detailed analysis shows that the market is dominated by German Länder and Spanish autonomous regions with sufficiently large funding needs for direct bond issuance. German Länder represented 85% of Euro zone sub sovereign issuance in 2012. Issuance by Spanish local and regional government represented 10% of total sub sovereign issuance in 2012.

Excluding German and Spanish issuers, regional and local government issuance in 2012 only stood at EUR 3.3 bn in 2012, representing only a small part of local authority funding needs. Small funding needs by bond market standards and the need for amortizing structures are the main obstacles preventing local authorities from raising funds directly in the bond market.

> Figure 5: Local and regional government bond issuance, EUR bn



Source: Dealogic Bondware

PUBLIC AGENCIES DOMINATE LENDING TO LOCAL AUTHORITIES IN A NUMBER OF COUNTRIES

Public Agencies provide an important source of funding in a number of European countries. The structures put in place vary widely from one country to the other:

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

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

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

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

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

2 Source Dealogic, all transactions in EUR issued by euro area local and regional government

Examples of countries with an important part of local authority funding provided by public agencies are:

> Netherlands: Bank Nederlandse Gemeenten is owned 50% by the Dutch government and 50% by Dutch Municipalities, Regions and Water Boards. Its market share in financing local and regional government in the Netherlands is well above 50%. No explicit government guarantee is in place, however the agency relies on strong implicit support from the Dutch government.

> Italy: Cassa Depositi e Prestiti holds a dominant position in the financing of Italian local authorities. Loans to Italian Municipalities, Regions and Autonomous provinces amounted to EUR 70 bn at the end of 2012, representing around 50% of Italian Local authority liabilities. 80% of shares are owned by the Italian government.

> Nordic countries: Funding of local and regional government in Sweden, Finland, Norway is Denmark is dominated by public agencies. Kommuninvest in Sweden, Municipality Finance in Finland, Kommunal-banken in Norway and KommuneKredit all control between 50% and 80% of the local government loan market. KommuneKredit and Kommuninvest rely on a joint and several guarantee from local authority borrowers, Municipality Finance relies on a guarantee from Local Authorities on a pro-rata basis and Kommunalbanken relies on strong implicit support from the Norwegian government.

> France has created Société de Financement Local as a government agency dedicated to the financing of the French local public sector. However, in contrast to the existing agencies in other countries, local government loans will be re-financed via covered bonds issued by Caisse Francaise de Financement Local.

> Long dated loans linked to specific investments are provided in a number of countries by state develop-ment banks. Examples are long dated loans linked to infrastructure projects provided by CDC in France or long dated loans provided by KfW Kommunalbank in Germany.

OTHER SOURCES OF FUNDING - MAINLY AN OPTION FOR SMALLER LOCAL AUTHORITIES

Commercial banks without public sector covered bond programs are also providing some loans to local and regional government. This is in particular the case for cooperative banking networks or local savings banks with a local and regional lending activity. However, financing very long-dated public sector loans by bank deposits is more adapted to the funding needs of smaller local authorities, but not a solution for those with significant funding needs.

More innovative structures have also been put in place, for example in France where public sector securitization transactions are being structured for buy and hold investors. Funding volumes raised via these transactions are however not very significant.

CONCLUSION

The decrease in public sector covered bond issuance over the past ten years has raised questions about the access to funding for local and regional governments in Europe. However, a major part of outstanding local government debt in countries like France, Germany and Austria is financed via covered bonds, despite the recent decline in issuance.

Alternative sources of funding exist but are limited to specific countries or to specific market segments:

> Direct bond issuance is only an alternative source of funding for sub sovereigns with important funding programs like German Länder, many Spanish autonomous regions or the larger French local authorities.

> Loans provided by commercial banks, in particular savings banks or cooperative banks, without access to refinancing via covered bonds are generally limited to local authorities with small funding needs. Other more innovative structures will only cover a small part of funding needs.

> In a number of countries, public agencies are well established and play a dominant role in financing local authorities. However, this activity is limited to the domestic public sector.

Looking ahead, the local public sector will continue to need a stable access to long dated funding in order to finance public infrastructure investments. Public sector covered bonds are well adapted to play a major role in financing these investments in the future.

1.12 USD & GBP COVERED BOND MARKETS

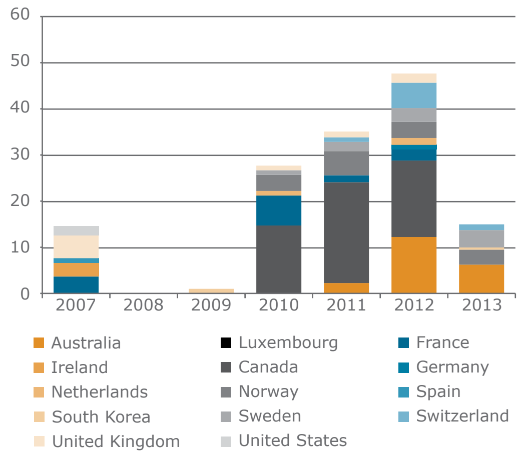
1.12.1 THE GROWING FOOTPRINT OF THE USD COVERED BOND MARKET

By Anne Caris and Rondeep Barua, Bank of America Merrill Lynch

STEADY ISSUANCE EXCLUDING CANADA

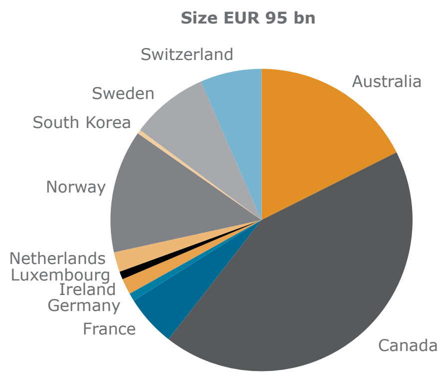
After material expansion in recent years, the USD covered bond market seems to have paused in 2013 (see Figure 1). New issuance (gross) during 1H13 reached USD 15 bn compared to USD 29 bn in 1H12 suggesting a 50% drop in volumes. That said yoy comparisons are somewhat meaningless given the absence of Canadian banks since the start of 2013. Following the finalisation of Canada's new covered bond legal framework in December 2012, issuers have been setting new programmes to comply with the new required eligible assets: cover assets are restricted to uninsured residential mortgages and covered bonds secured by insured residential mortgages can no longer be issued (see the Country Chapter on Canada for more details). Excluding Canada from 2012 new issuance statistics, new issuance has been overall stable (-2% yoy) reflecting the strategic importance of the USD covered bond market.

> Figure 1: USD-denominated benchmark issuance by country end-June 2013 (USD bn) [1]



Source: BofA Merrill Lynch Global Research; [1] Excluding FRNs

> Figure 2: USD-denominated outstanding benchmarks by country end-June 2013 (%)



Source: BofA Merrill Lynch Global Research; [1] Including taps; excluding FRNs

As Canadian issuers launch their new covered bond programmes during 2H13, we expect the market to take off again, with Canadian banks having been active participants traditionally. However, new issuance might be less buoyant than in the past, as seen so far with Australian and European banks, for a number of reasons: declining/softening mortgage lending; attractive funding alternatives; collateral management including in Australia and Canada given the issuance limit; and regulators' concerns regarding asset encumbrance. SEC registration (a new route being taken by a few Canadian and European issuers) might also delay new issuance in the short term.

A MARKET WITH ITS OWN FOOTPRINT

The USD covered bond has established its own specificities since its launch and now deviates from its EUR counterpart in a number of ways (notably as a result of the crisis). We highlight the key differences:

- > **Issuers:** initially, the USD covered bond market was a funding alternative to the largest European covered bond issuers for diversification purposes (FX, investor base, etc). Since summer 2011, when the Eurozone sovereign crisis escalated, it has been restricted to the strongest European banks only. This is unlikely to change until market concerns on the Eurozone subside. In contrast, non-European banks (Australian and Canadian) cruised through the crisis and have increased their market shares significantly, accounting for about 60% of outstanding USD-denominated covered bonds in June 2013 (see Figure 2). Going forward, we expect the strongest European banks to access the market assuming a favourable basis swap (see below).
- > **Covered bond characteristics:** the size of USD-denominated covered bonds is still typically "jumbo" like (i.e., USD 1 bn minimum) with USD 1.35 bn on average in 1H13 compared to USD 1.5 bn in 2012. In Europe, the average size dropped to EUR 0.8 bn from EUR 1 bn as banks adjusted for a number of factors (e.g., market volatility/execution risks, ALM diversification, lower funding needs and lower threshold for index inclusion). Maturities in the USD market also remain shorter at 4.7 years on average in 1H13 vs. 6.9 years in EUR. The maturity of covered bonds in the USD market has been traditionally 3- or 5-year, while we have seen a wider maturity range in Europe, which has responded notably to different investor needs. USD covered bonds can be issued under a separate USD programme but are backed by the same cover assets as covered bonds in EUR or other foreign currency (typically residential mortgages) and must meet the same legal requirements.
- > **Ratings:** AAA rated covered bonds have remained the norm in the USD market and therefore tend to be an investor requirement for now. This is in contrast to the EUR market which, following major downgrades in recent years, is a non-AAA market, meaning that rating sensitivity is mainly around the following thresholds: A to BBB and investment grade to non-investment grade. The AAA requirement limits the club of possible USD issuers, although we have seen exceptions (upon fundamentals, pricing, etc). It also means that the USD market remains more sensitive to the loss of a AAA rating than the EUR one, bearing in mind sustained rating pressures. A range of European issuers active in USD shows limited leeway between the bank and covered bond ratings. Non-European banks currently benefit from a greater buffer given banks' higher ratings. Regarding covered bond ratings, it is important to remember the linkage between sovereign, bank and covered bond ratings translating into higher rating volatility versus other asset classes, e.g., RMBS.
- > **Registration:** covered bonds have been offered mostly under Rule 144A, meaning they can be sold to Qualified Institutional Buyers only under specific restrictions. That said there might be a wave of new SEC registration following Royal Bank of Canada and, more recently, Bank of Nova Scotia and Bank of Montreal. This is rather significant as some of the 144A investors have been close to reaching their allocation limit for the product. SEC registrations also opens the door to a wider investor base including to retail clients thus putting USD covered bond issuers on an equal footing with UCITS issuers in Europe (please see dedicated box below).
- > **Transparency:** investors in the USD market continue to be US based to a large extent, even though we have seen non-negligible diversification especially in 2013 (see below). A large majority of US investors tends to have an ABS/RMBS background so that transparency and granular information is at the forefront of their request for investing in covered bonds. This is less the case in Europe where investors' focus is more on consistent and comparable aggregate data due to a different background or approach to the product given dynamic cover pools.
- > **Growth potential:** the implementation of new covered bond legislation in more countries should help broaden the USD market. It is a work in progress in a range of countries. For legislation in non-European countries, the USD market might be a more natural home than the EUR market. Covered bond legislation is also being contemplated in the US and would naturally have the most impact on that market.

SEC REGISTERED COVERED BONDS: ADVANTAGES AND DISADVANTAGES

By Jerry Marlatt, Morrison & Foerster LLP

SEC registered securities are the gold standard in the U.S. market. Privately placed securities, such as 144A securities, are 'restricted' securities and are subject resale and transfer limitations. This results in a limited secondary market in the securities and many investors have limited authority to invest in such securities. In contrast, SEC registered securities are freely tradable in the secondary market, are included in various bond indices and have much more liquidity. Accordingly, SEC registered securities have the broadest investor base, including retail, and obtain the best pricing.

Registration of securities with the SEC commits the issuer to filing periodic reports with the SEC and exposes the senior officers of the issuer to personal liability for material misrepresentations and omissions in the filings. For those issuers that already have a class of securities registered with the SEC, such as senior debt or equity, there is only a small additional burden from the registration of covered bonds. This is generally the case for the Canadian banks. A number of U.K. and other European banks also are already registered with the SEC and, therefore, may be expected to register their covered bond programs[1].

It is also possible for foreign banks to issue covered bonds under section 3(a)(2) of the Securities Act by utilizing their U.S. branch or agency. To date no 3(a)(2) covered bond offerings have been made, although several banks offer their senior debt in the U.S. under section 3(a)(2). However, with the adoption by the SEC of the rule change eliminating the prohibition of public communications in private offerings, the advantage of section 3(a)(2) over a private offering is narrowed considerably.

Royal Bank of Canada (RBC) was the first issuer to register covered bonds with the SEC, making its initial offering last September. Recently both Bank of Nova Scotia and Bank of Montreal have filed registration statements with the SEC for their covered bond programs. It is expected that Toronto Dominion Bank and Canadian Imperial Bank of Commerce will follow in due course. Both RBC and CIBC have received approval from CMHC, the Canadian covered bond regulator, and are now registered covered bond programs under the new legislation in Canada. RBC has just launched its first issue of CMHC-registered covered bonds in a USD 1.750 bn offering in the U.S.

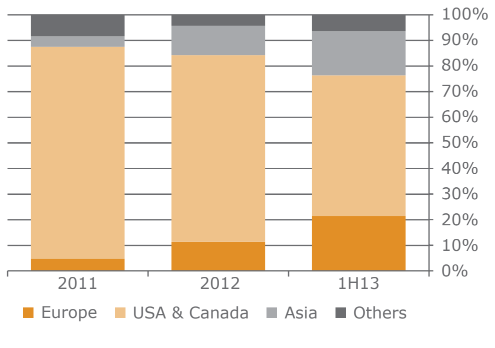
INVESTOR BASE: DIVERSIFYING AWAY FROM THE US?

The majority of investors buying USD covered bonds have been US based. However, the investor base has diversified in recent years, especially in 2013 with US investors being allocated 50% on average of the new transactions compared with 62% in 2012 and 79% in 2011 (see Figure 3). European investors have been much more active, now accounting for 20% on average, notably due to the lack of supply in the EUR market (driven by the ECB LTROs, deleveraging, collateral management, etc). Further arbitrage between the USD and EUR can be expected on the cost of basis swap as discussed below. Interest in covered bonds from Asian investors has also grown in recent years (a trend visible in the EUR market as well) as covered bonds can represent an interesting spread pick-up over sovereign bonds in some countries with still limited volatility.

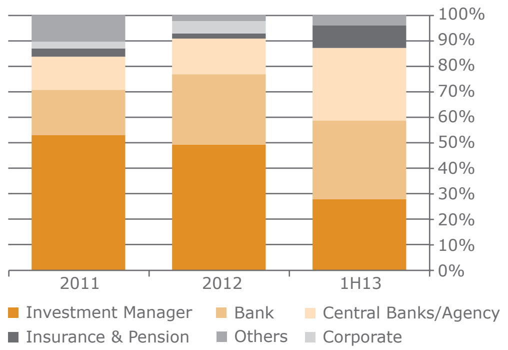
1 Barclays Bank, Credit Suisse, Deutsche Bank, HSBC, Santander and RBS are among the large European banks that already report to the SEC.

The rising share of new non-US/foreign investors could reinforce the technical factors of the USD market (market technicals), if demand were to exceed supply significantly. The entrance of foreign investors has also reduced dependence on investment/asset managers to the benefits of banks and central banks – resulting in a broader USD investor base and some convergence with the EUR market with no real risk of cannibalisation given current limited supply globally (see Figure 4).

> FIGURE 3: ALLOCATION OF NEW USD BENCHMARK ISSUES BY GEOGRAPHY



> FIGURE 4: ALLOCATION OF NEW USD BENCHMARK ISSUES BY INVESTOR TYPE



Source: BofA Merrill Lynch Global Research

SECONDARY MARKET TRENDS & OPPORTUNITITES

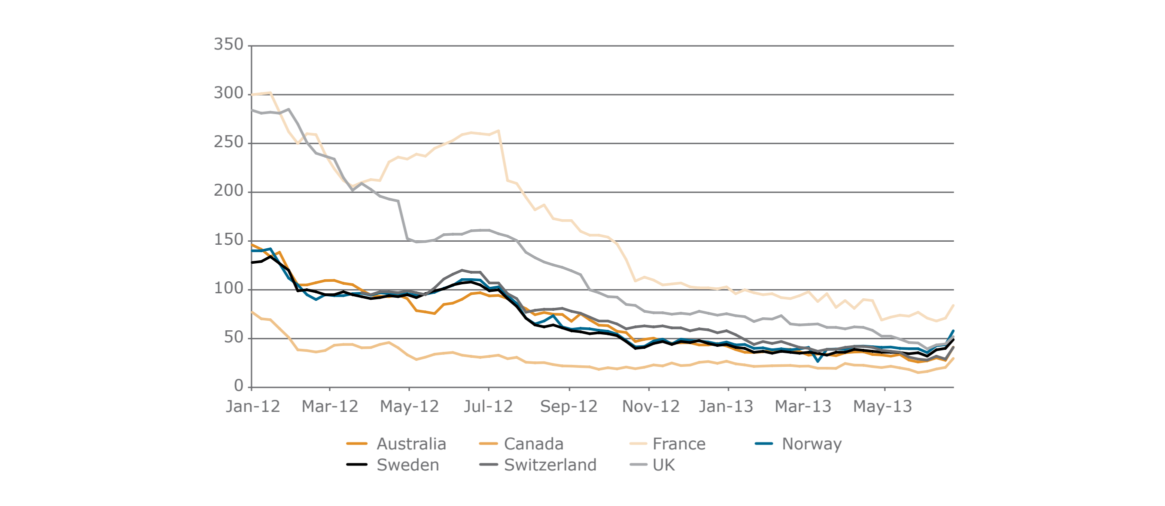
Spreads have converged across countries but tiering remains

In the secondary market for USD covered bonds, there is clear tiering across countries, though this has narrowed since early 2012. The relatively strong performance of the Canadian economy, combined with a robust banking sector and conservative mortgage market, has helped contribute to the stability of the covered bond market (with the majority still being backed by insured mortgages) and Canadian covered bonds generally trade at the tightest levels in the USD market. After Canadian covered bonds, the next tier includes Australian covered bonds and some of the stronger European markets, such as Scandinavian and Swiss covered bond markets. UK and French covered bonds tend to trade wider, largely as a result of greater macroeconomic concerns in these countries (Dutch USD covered bonds trade wider too, though there are few bonds outstanding).

This tiering was far more evident in 2012, and has compressed substantially since last summer, prompted by policy action and statements by the ECB and the Federal Reserve among others. As concerns over the macro-economic situation in Europe eased in the second half of 2012 and investors searched for yield, broader fixed income markets rallied and, as shown in Figure 5, French and UK USD covered bonds in particular benefited from the rally in USD covered bond markets.

Covered bonds have certainly not been immune to spread widening, and recent volatility sparked by signs that the Federal Reserve may consider tapering quantitative easing earlier than expected may result in some decompression of spreads, as concerns increase again over the health of weaker European economies and the impact of rising interest rates. However, we note that covered bonds have tended to perform well when compared to bank unsecured and sovereign spreads, generally trading tighter than bank unsecured bonds and typically showing less volatility than sovereign spreads.

> FIGURE 5: AVERAGE USD COVERED BOND SPREADS BY COUNTRY



Source: BofA Merrill Lynch Global Research

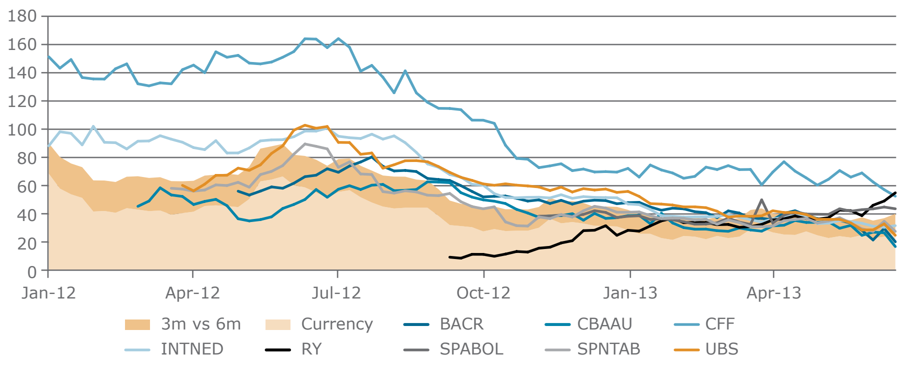
Supply, macro and idiosyncratic issues are the main spread drivers

The main spread drivers for USD covered bonds are supply technicals, macroeconomic factors and idiosyncratic issues. While the EUR covered bond universe is shrinking (with negative net supply), the USD universe is increasing. In the EUR market, there is therefore more of a supply technical factor pulling spreads tighter. In contrast, in the Canadian market, expectation of new supply under the new legal framework resulted in some widening of spreads earlier in 2013 as accounts rotated out of existing bonds and in preparation for new supply. Typically, EUR new issuances tend to be oversubscribed by greater multiples than USD deals.

Spreads have been more stable in the USD covered bond markets in 2013 than in 2012 as, until recently, an accommodative central bank policy helped provide stability to fixed income markets in general. With indications from the Federal Reserve that policy tightening may begin sooner than expected, non-European markets may show greater resilience than European markets in a period of greater volatility, given continuing economic weakness in Europe. However, volatility in the USD market cannot be excluded as, for example, a weakening Chinese economy may negatively impact the Australian covered bond market.

As well as broader supply and macroeconomic factors, idiosyncratic factors continue to cause differences across countries and issuers. At a country level for example, although Scandinavian bonds tend to trade at fairly tight levels compared to elsewhere in Europe, we can see that Norwegian covered bonds tend to trade wider than Swedish covered bonds, due largely to greater concerns over the housing market in Norway. Within countries, at the issuer level, Northern Rock covered bonds are examples of bonds that tend to trade wider than those from other UK issuers as the bank continues to be wound down.

> FIGURE 6: USD MINUS EUR ASSET SWAP SPREAD AND INDICATIVE SWAP COSTS



Source: BofA Merrill Lynch Global Research, Bloomberg

Opportunities exist across EUR and USD markets

Differences in the movement of EUR and USD spreads provide some arbitrage opportunities across the two markets. Figure 6 shows the difference in spreads between a USD bond and a EUR bond of similar maturities (mostly 4-5 years) from several issuers which have issued in both markets. We also show indicative costs of swapping currencies (based on EUBS4 on Bloomberg) and swapping 3M payments typical for USD bonds to 6M payments typical for EUR bonds (EUBSV4 on Bloomberg). Differences in the investor base and issuance dynamics in the two markets are two potential explanations for opportunities appearing across the two markets.

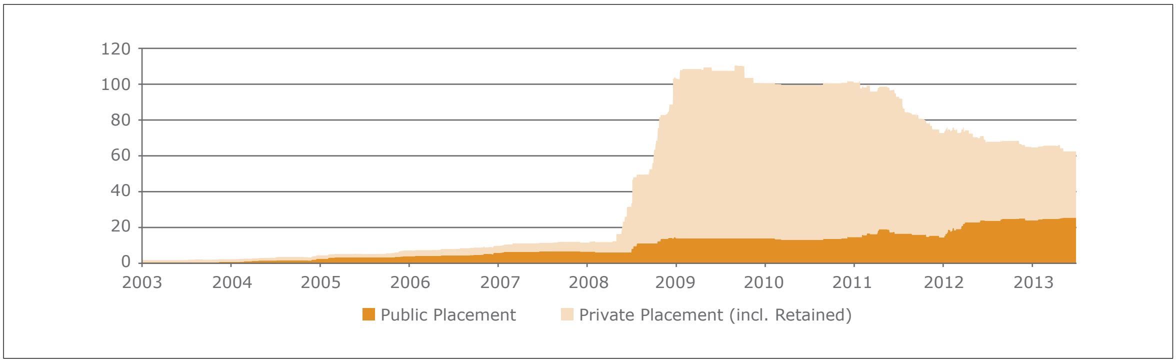
Broadly speaking, we can see that there have been times when USD covered bonds have been good value compared to EUR covered bonds; for example, in the second half of 2012, when the difference between spreads for the two markets appeared to more than offset the cost of the swaps in several cases. In June 2013, we saw EUR covered bonds sell off more than USD covered bonds in the renewed market volatility, thus offering greater value than USD comparables at that point – an illustration of possible arbitrage opportunities between the two markets.

1.12.2 GBP-DENOMINATED COVERED BOND MARKET

By Jan King, Royal Bank of Scotland

Along with the US-Dollar denominated market, the Pound Sterling covered bond segment has increasingly seen expansion over the past two years. Total outstanding publicly placed Sterling covered bonds amount to c.GBP 25 bn, or around 40% of the overall volume (c.GBP 62.5 bn) including private placements and retained issuance. The total outstanding volume peaked in August 2009 following high issuance volumes of retained covered bonds of which large parts have subsequently been redeemed or matured within the next three years.

> Figure 7: Outstanding Volume of GBP-denominated Covered Bonds over time

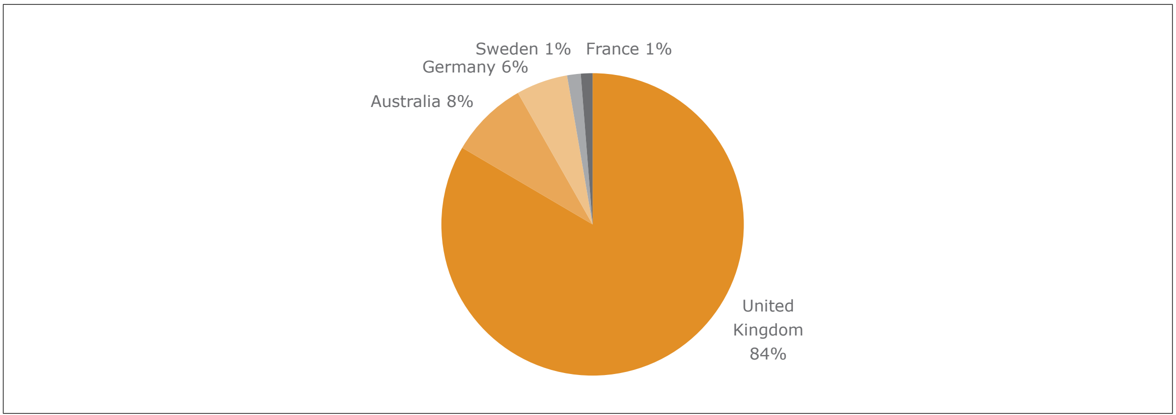


Source: Dealogic, Bloomberg, RBS

In 2012, publicly placed covered bond supply in Pound Sterling reached a new record volume of about GBP 13 bn, double the record volume of the previous year, driven by strong demand from insurance companies at the long end of the curve as well as money market funds and bank treasuries at the shorter end. The GBP market is still in its nascent stage, however, with total supply still a fraction of the issuance amounts we see in the EUR or USD segment.

Encouragingly, further non-domestic issuers from Australia, Germany, the Nordics and France have chosen to issue in Sterling over the past year. Issuance in non-domestic currencies has a number of advantages from a CB issuer perspective. Besides opportunistic issuance depending on the basis swap valuations to optimise the funding mix, issuers are able to strategically broaden their investor base. Another advantage for issuers is that non-euro issuance for instance reduces the supply in Euros, which should support the valuations of the outstanding EUR benchmarks of the particular issuer and might free up credit lines at investors. Last but not least, issuance in non-domestic currencies can be used to hedge foreign-currency denominated assets in the cover pool without the need of swapping the currency risk.

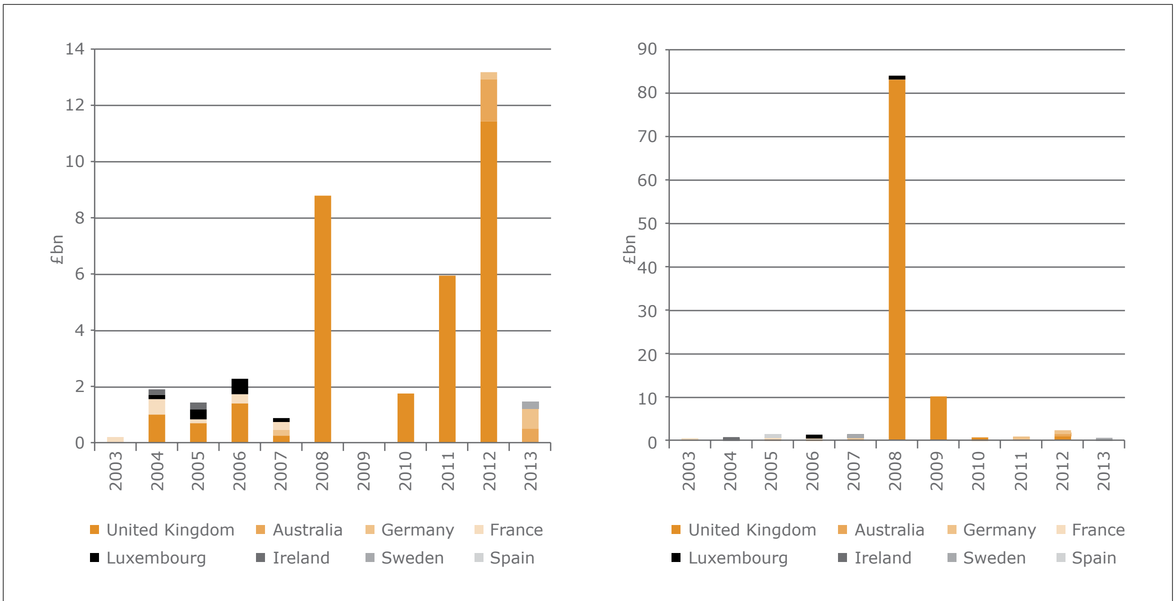
> Figure 8: Outstanding Volume of Public Deals by Country



Source: Dealogic, Bloomberg, RBS

The Figures below show the issuance patterns in the Sterling covered bond segment since 2003, separated between publicly placed deals and private placements (according to the definition of the ECBC Statistical working group), using Dealogic data.

> Figure 9: Publicly placed GBP-denominated Covered Bond Issuance (left) ; GBP-denominated Covered Bond private placements incl. retained issuance (right)

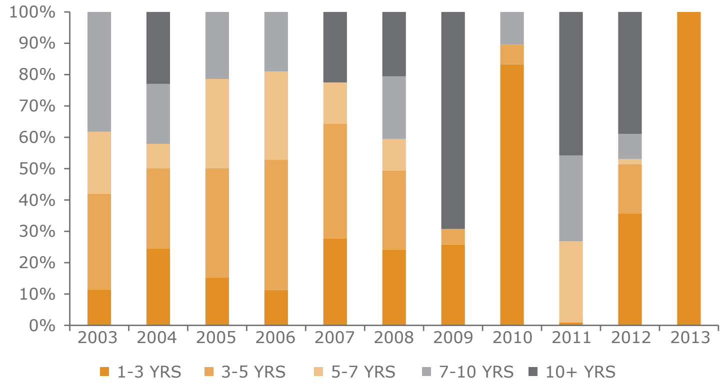


Source: Dealogic, RBS

As is shown in the previous Figure, large volumes of Sterling-denominated covered bonds were issued in 2008 (c.GBP 85 bn) and 2009 (c.GBP 10 bn) that were not publicly placed in the market. Most of these issues were retained by the issuers at a time when the Bank of England provided funds under the Special Liquidity Scheme for which these retained covered bonds were used as collateral.

In the years up to 2008 only a small percentage of new issuance came with maturities longer than seven years. With the exception of 2009 when no syndicated publicly placed issues were sold, demand for long-dated GBP-denominated covered bonds has started to pick up in 2011 and 2012.

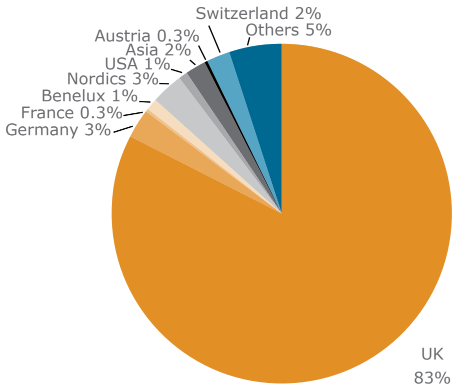
> FIGURE 10: MATURITY BREAKDOWN OF NEW ISSUANCE (PUBLIC AND PRIVATE PLACEMENTS)



Source: Dealogic, RBS

The investor base for Sterling-denominated covered bonds is largely based in the UK. Analysing deal allocation statistics of primary market transactions since January 2011 shows that just over 80% was placed with UK investors with the remainder spread almost equally across Europe and overseas.

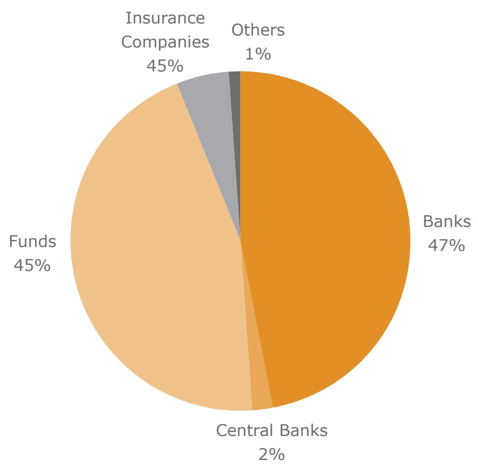
> FIGURE 11: INVESTOR PARTICIPATION BY GEOGRAPHY



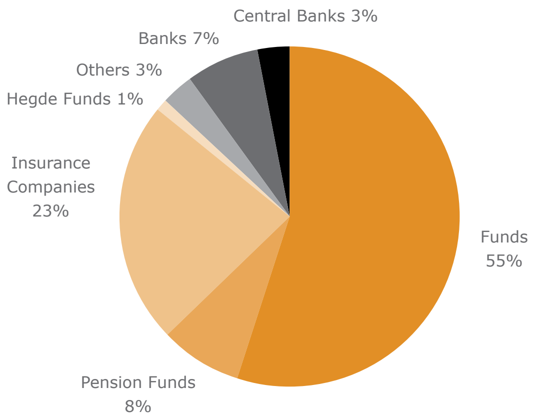
Source: Publicly available deal allocation statistics, RBS

The breakdown of the investor base by type varies considerably between floaters and fixed-coupon bonds. While asset managers have a large share in both cases (45% of FRNs, 55% of fixed-coupon bonds), banks have bought only 7% of fixed rate paper compared to 47% of FRN issues since 2011. Insurance companies and pension funds have accounted for just over 30% of fixed rate covered bonds. This is to a large extent due to the fact that the majority of fixed-rate bonds in 2011 and 2012 were issued at the long end of the maturity spectrum.

> Figure 12: Investor Participation by Type (FRN)



> Figure 13: Investor Participation by Type (Fixed)



Source: Publicly available deal allocation statistics, RBS

THE WAY FORWARD

Issuance volumes of Sterling covered bonds in the first six months of 2013 have been subdued - partly driven by the lower funding needs of the UK banks which proved to be the backbone of the supply over the last couple of years. The Bank of England's Funding for Lending Scheme, the lower loan demand combined with a general deleveraging trend in the industry resulted in much lower funding needs at the UK banks. The supply from non-domestic covered bond issuers is highly depending on the basis swap environment which has been proved to be very volatile over the years. Moreover, the two ECB long-term LTROs have significantly lowered the wholesale funding needs of European banks, also impacted Sterling covered bond supply from those entities. At the same time, demand for Sterling denominated covered bonds continues to increase as more and more investors are attracted to this product.

1.13 INVESTOR PERSPECTIVE

1.13.1 INVESTOR'S PERSPECTIVE

By Ralf Burmeister, Deutsche Asset & Wealth Management

Another turbulent year on the capital markets and the covered bond has so far again fulfilled its mission. While it is fair to say that at least in the first few months in 2013 the situation has relaxed to a certain degree, the overall context of risk aversion against sovereign bonds, spread volatility and negative rating trend still weigh on various countries and, in turn, on banks as well as their outstanding covered bonds. Due to especially bold actions by central banks, amongst other results, the liquidity situation for banks has eased and combined with low growth rates, the supply and demand mechanisms also helped the spreads to stabilize and even tighten further.

As investors tend to follow various motives when acquiring covered bonds, it is difficult to make statements about the importance of certain market developments or to simply rank certain trends as the investor base itself surely is not homogenous. However, being an active market participant, we consider the four points discussed below as relevant for future positive development of the overall Covered Bond market.

THE EMERGENCE OF NEW STRUCTURE: WHAT CONSTITUTES A COVERED BOND?

The emergence of new structures and covered bond legislations is a quite common phenomenon. While it is fair to say that this trend has been there for quite some years and might have been "just" interrupted by various events throughout the crisis, the emergence of new asset classes being used as collateral backing bonds from e.g. long standing covered bond jurisdictions being marketed as covered bonds is a relatively new aspect. Due to overall political interest to boost growth in the economy, one has to mention loans to small and medium sized enterprises (SME) here probably in the first place. While we would simply argue that SME loans tend to have different parameters when it comes e.g. to probability of default or loss given default in comparison to traditional cover assets like mortgages or public sector loans, there are additional potential pitfalls when trying to introduce a bunch of new assets to the established covered bond market / to the established covered bond investor community. Firstly, as with every new product, investors have to ensure that they have sufficient expertise at hand to analyze structures as well as underlying credit quality. Given the tremendous growth and the range of jurisdiction in the covered bond universe in recent years, it is fair to assume that new asset classes like SME cannot be added overnight in the investment process also partly owed to the human factor. Secondly, the basic promise of covered bond issuers is to use the best assets to back the outstanding covered bonds. Taking ever larger portions of a bank's loan book must have by definition an effect on the credit quality of selected assets. With asset encumbrance raising and leading to a stronger tranching of the liability side of a bank's balance sheet, there might be unwanted consequences for the underlying senior unsecured rating of the issuer when new asset classes are taken one by one and being refinanced through innovative covered bond structures, which in turn does not automatically lead to higher financial stability. Besides the question of credit quality, one also has to consider the average tenor of underlying loans and furthermore, the turnover in the cover pool. While traditional covered bond assets like mortgages and public sector debt on average have long loan maturities, and therefore in established covered bond programmes the turnover and the dynamics in the cover pool are not overly pronounced, this is not necessarily the case in other asset classes serving as collateral due to generally shorter loan tenors. At the end, one has to question whether any kind of new covered bond instrument being backed by new classes of assets should receive the same regulatory treatment, may it be in terms of risk weighting or treatment in an upcoming European resolution regime.

As we have seen so far the emergence of bonds being backed by other collateral than mortgages or public debt only to a small extent looking at outstanding volumes, it is nevertheless interesting to note that the perception of these instruments differs with regard to covered bond index providers. Therefore, it is up to the investor to define what has to be considered as a covered bond and therefore what is investible in the covered bond portfolio context and what not, as the index providers (and obviously not only them) potentially come up with different conclusions. So besides asset allocation decisions, it also comes down to product definition and possibly product restrictions for every investor.

Given the discussions in various EU countries to introduce covered bond legislations allowing for new asset classes besides established ones like mortgages and public sector debt, we believe that purely a binary distinction like "product has special law / has no special law " is insufficient to reflect the growing complexity in the covered bond universe. We like to emphasize in this context the implicit obligation of every investor in the covered bond space to come up with a covered bond definition on its own as e.g. even the latest version of CRD/CRR does contain a clearly defined set of assets and requires a special covered bond legislation but in turn comprises more assets than the previous CRD version and is by definition subject to changes over time. We believe that the definition of the scope of investible products is too important to leave it in the hands of e.g. either politics or index providers anyway.

TRANSPARENCY AND LABELLING

One of the landmarks in this context surely is the introduction of the ECBC Covered Bond Label in late 2012, which partly also addresses the discussions as mentioned above when trying to define a covered bond. We therefore welcome the introduction of the label and would like to point out furthermore to the template being introduced by the CBIC (Covered Bond Investor Council). While to our understanding it has been made relatively clear that for the time being the ECBC Label will not gain an official status in a way that e.g. banking supervisors or central banks will somehow rely on the ECBC Label within any given covered bond activity. Nevertheless, it is fair to state that there is a broad market consensus that the Label initiative has been a major improvement but not the end of the road towards more and comprehensive information on covered bonds. Furthermore, one has to state that information on the issuer / the bank behind the covered bond becomes more relevant like e.g. information on asset encumbrance. So there is still no room for complacency when it comes to transparency and still there is plenty of room for issuers to differentiate themselves vis-à-vis the investor community by doing individual investor relation work besides providing data for the ECBC Label.

In addition, it is worthwhile to mention that the current initiatives with regard to transparency, either from issuer or investor side are one element which makes covered bonds a quite unique asset class in the fixed income universe. Furthermore, these initiatives need to be developed further in order to catch up with the growing complexity and innovation mentioned in the first section.

TRADABILITY

It is fair to assume that investors in the meantime have got used to the rollercoaster ride when it comes to actually buying and selling covered bonds. Volatility in spreads has been still on elevated levels, but it should not be considered as too controversial to state that the main cause of volatility has been outside the covered bond market and that covered bonds, in most cases, fell prey to developments in the sovereign bond market and so they have obviously been exposed to changes in the creditworthiness of banks, acknowledging that sometimes it is very difficult to make a clear cut distinction between those two factors. Given the supply and demand mechanics as outlined above in the first half of 2013, there was a certain market bias towards being long in covered bonds, leading to a partly subdued activity in the secondary market. So while volatility and availability of (covered) bonds is no special topic as such, but rather something to deal with in every day operations as portfolio manager, it is worth pointing out that we are confronted with upcoming new regulation on the liquidity of banks, namely the Liquidity Coverage Ratio (LCR) regime with its distinction in high and extremely high liquid asset. As the fine tuning and calibration in our understanding still has to be done on the level of the European regulators on how to assess the liquidity of various markets, we simply want to raise the point that subdued secondary market activity is not necessarily a sign of low liquidity in the sense of tradability of that particular instrument – selling covered bonds even in the lower rating categories was rather an easy task in the first half of 2013. Vice versa it turned out sometimes to be tricky to acquire certain bonds in decent volumes which again should not be seen as a negative factor when trying to determine the liquidity of a capital market instrument. To be frank, it seems a quite challenging task trying to find a set of rules and/or a quantitative formula which at the end of the day forms the prerequisite for the recognition as a liquid asset in a regulatory context. So here we find another example of regulation outside the covered bond market (as we speak about new liquidity provisions for banks) which surely has its repercussions on the covered bond itself. Nevertheless, it also underpins the fact again that the complexity is growing and that the supply and demand play on the covered bond markets –which is more or less another expression for tradability- is obviously also sensitive to changes in the regulatory landscape. Having monitored the emergence of new regulation over the last couple of years, we remain at our constructive view that regulators per se are supporting the covered bond market as such in the light of its importance for the overall economy, but we still remain cautious as we are aware that despite good intentions there might be unintended negative consequences as different pieces of new legislation and regulation are now being put in place in parallel.

THE SOVEREIGN LINK AND BAIL-IN

A responsible investor in covered bonds ought to know what his/her legal position is and what claims can be made upon either issuer or cover pool. The interesting question has nevertheless always been whether the rights on behalf of the investor are enforceable in each and every scenario, especially if the state of domicile where the majority of assets are located is in turmoil.

As there is no easy answer to this and as it is certainly appropriate to make a case-by-case assessment here, there will never be by definition a complete de-linkage from state of domicile and covered bonds as a bank funding tool. This part of the sovereign link is also reflected to a certain extend in the various rating agencies methodologies and can be summarized under the topic of sovereign ceiling or rating caps / restrictions due to state of domicile. Accordingly, the current efforts and initiatives in reducing the bank-sovereign link are to be welcomed, but we believe it is helpful to remind ourselves from time to time that there are limitations to the de-linking of banks and sovereigns.

Within the political initiatives, one has probably to mention the bank resolution regime including bail-in as the most relevant one or at least the one with the potential of doing the biggest damage to the market if covered bonds were to be included by law / by regulation in a resolution scenario in the future. As the final rules are not yet out by the time of writing, it is surely difficult to make statements in this regard. The general trend in exempting covered bonds from resolution scenarios is warmly welcomed by the investor community. However, there has been some noise and also some kind of opposition lately when it comes to the treatment of deposits. We would refrain from arguing that the covered bond per se is risk-free, but having said that the low risk profile has been demonstrated throughout the crisis. As the sovereign bond markets, besides other factors, also suffer from the fact that the financial system does need low-risk to ideally risk-free assets which the sovereign bond market can no longer supply to the extend it used to in the past, we argue it is not recommendable to cast shadows of doubt on the covered bond market as one possible source of low risk assets, given e.g. simply the regulatory requirements for bank's liquidity as mentioned before. Given the regulatory tailwind for the covered bond product in recent times, we are cautiously optimistic that the final wording on the resolution regime will not alter the capital structure and the legal position of covered bond investors in a way that would induce market outflows.

To sum it up, the covered bond market is heading in the right direction but obstacles remain. The various dialogues between issuers and investors need to continue in order to ensure the safety and the soundness of the asset class.

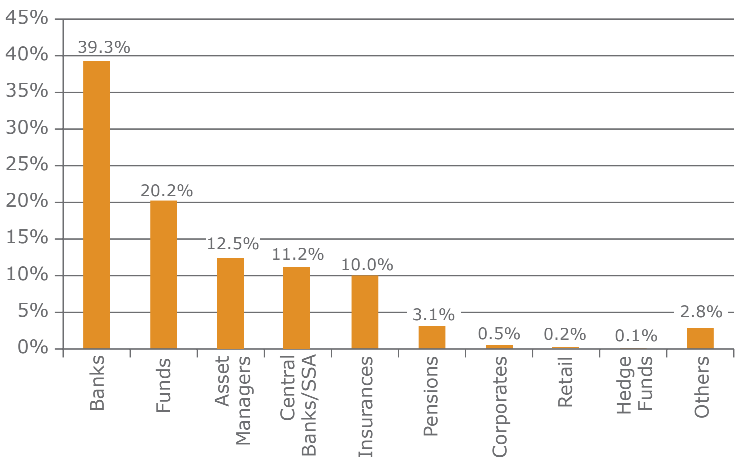
1.13.2 INVESTOR BASE

By Matthias Melms, NORD/LB

In the period from January 2011 to April 2013, a volume totalling approximately EUR 300bn was issued in the covered bond primary market, considering euro-denominated covered bonds in benchmark format, in other words, securities with a minimum volume of EUR 500m at the time of issue which were placed publicly. Covered bonds that are retained by the issuer and, generally used for central bank operations are intentionally excluded from this category. Issuing activities were not evenly distributed across the various periods but reflected a seasonal pattern in both 2011 and 2012, with a relatively strong first six months of the year in terms of volume followed by a weaker second half of the year. To analyse investor behaviour, we have divided each year into periods of six months. However, in view of the time going to press, data for the first half of 2013 was only available up to 30 April (four months). Details regarding the types of investors and countries of origin of investors were taken from the deal reviews. In view of the fact that some groups of investors are combined, for example central banks and agencies, and countries are grouped together (e.g. Germany and Austria), for the purposes of providing an assessment, we have used the presentation which we believe occurs most frequently and adjusted the information accordingly. The inclusion of investors and countries that rarely make an appearance has proved difficult. They are often included under the generic category "Others". In addition, discrepancies were identified in data on one and the same issue in some cases. As a result, variations may occur in respect of detailed data.

Distributed across the entire period under review from January 2011 to April 2013, banks accounted for an average of 39.3% of demand in the euro covered bond primary market. Funds followed in second place with 20.2%, then asset managers (12.5%), central banks and agencies (11.2%) as well as insurance companies (10%). Another important group of investors comprises pension funds, which accounted for an average share of 3.1% in the period under review. Corporates (0.5%), retail investors (0.2%) and hedge funds (0.1%) were less important groups of investors. Yet, in some deal reviews, they are listed separately. Other investors accounted for a share of 2.8%. However, this includes details regarding the above-mentioned investors if their share is within a range which was considered to be too small to be shown separately.

> FIGURE 1: INVESTORS IN THE COVERED BOND PRIMARY MARKET (EURO, BENCHMARK)

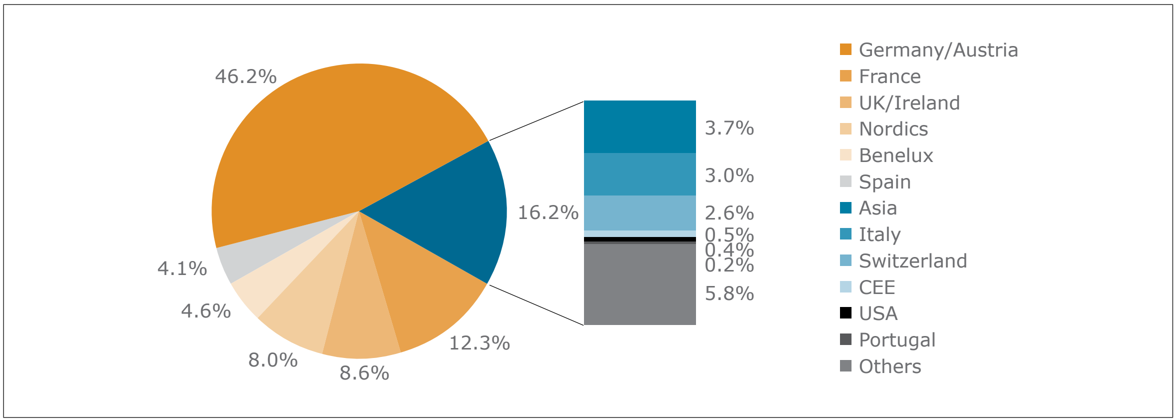


Source: market data, NORD/LB Fixed Income Research

As the investor group which accounted for the highest demand for covered bonds in the past $2^{1/3}$ years, banks preferred issues launched at a mid swap spread lower than 50bp according to the data. With regard to such securities, the share of banks amounted to 46%, compared with 40.2% for all issues. Conversely, covered bonds with a mid swap spread in excess of 100bp at the time of marketing were more popular among funds (25%) and insurance companies (14%). Banks, which accounted for a share of 32% in respect of such issues, tend to have limited interest in such covered bonds. We interpret this data to the effect that a high spread reflects increased risk. Against the backdrop of the European debt crisis, credit risk departments reduced many credit facilities and imposed prohibitions on new business with certain counterparties especially in peripheral countries. Bank treasuries are therefore not really in a position to invest in securities with an above-average spread (in this evaluation: ≥ mid swap+100bp), which were significantly affected by the financial crisis in the period from 2011 to April 2013. In search for higher yield, investors who tend to invest in covered bonds featuring an above-average spread are usually those who in turn need to deliver a return for their own investors. This explains why the share of investment funds was around 5% higher at 25% for this type of securities than their average rate of participation. The same also applies to insurance companies, which account for a share of demand of 14% in relation to issues with a high spread. This is 4% higher than the overall average demand from insurance companies.

The breakdown of investors according to maturity brackets provides further insight regarding investor behaviour. Demand from banks was above average for securities with maturities ranging from 0 to 3 years (45% vs 39% on average). Conversely, the demand from banks was below average in respect of long maturities. Their demand share for securities with maturities of 7 to 10 years was down to 34% and further decreased to as little as 19% for issues with maturities of more than 10 years. The rate of participation of asset managers and investment funds showed no unusual patterns in terms of the maturity distribution. However, there is particular interest among insurance companies for issues with medium and long maturities. Their share was 16% for bonds with maturities ranging from 7 to 10 years and, therefore, 5% above average. With regard to covered bonds with maturities of more than 10 years, the share of insurance companies even rose to as much as 36%. This pattern indicates that insurance companies attempt to match the maturities of their payment obligations with bonds with long maturities and manage their balance sheets as part of asset/liability management on the basis of securities with long maturities.

> Figure 2: Investors by region of origin



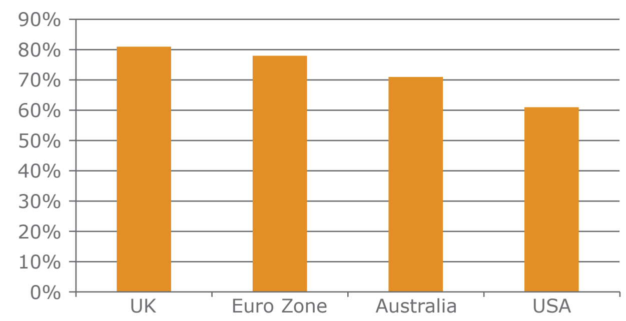
Source: market data, NORD/LB Fixed Income Research

The distribution of investors by countries of origin highlights that German and Austian investors account for almost half of the demand in the primary market. A share of 46% during the period under review makes the region Germany and Austria the most important country for placing covered bonds, followed by France (12%), the UK and Ireland (9%) as well as Norway, Sweden, Finland and Denmark (8%), which are combined under the group of "Nordics". Investors from the Benelux (BE, NE, LUX) countries (5%), Spain (4%) and Italy (3%) played a less important role during the period under review. Asian investors accounted for 4% of demand while demand from US investors was less than 1% in total.

However, it should be noted that, here too, investors who invest only sporadically are frequently combined under "Others". On average, almost 6% of demand was attributable to countries of origin that are not named separately. The dominant position of German and Austrian investors is a reflection of the surplus demand for Pfandbriefe, in our opinion. The volume of Pfandbriefe outstanding has halved in the past ten years and fell below the EUR 500bn mark in the first quarter of 2013. Coupled with this, a shift in demand from domestic investors is evident, as they increasingly invest in covered bonds issued under other jurisdictions with a view to redressing the imbalance caused by surplus demand.

The analysis of the behaviour of investors with regard to issues from their respective countries and/or regions of origin produces a different result. It seems that investors prefer covered bonds from their own home markets. At 72% (German covered bonds) and 74% (Austrian covered bonds), German and Austrian investors respectively account for the major share of the investor base when it comes to domestic issues, whereas their share across all issues amounts to 46%. The same pattern is evident in almost all of the markets and regions observed. This is particularly obvious for French issues, of which 31% were taken up by French investors (average: 12%), Italy, where local investors accounted for 32% of demand (average: 3%) and Spanish issues. With regard to the latter, the share of domestic investors amounted to 29%, whereas the share of Spanish investors across all issues accounted for only 4% of demand. This data points to the fact that investors are subject to a significant home bias. As a rule, obtaining information about the domestic market in each case involves less effort than for foreign markets. Another reason may lie in the existence of country limits, which represent a restriction for investors and prevent their investments in foreign markets on a large scale. The aspect of opportunity costs has also been an important factor in the last three years. In an environment with significant interest rate gaps between countries, it is self-explanatory that investors from a country where interest rates are at a higher level in relative terms do not invest in securities from another country with comparatively low interest rates. This would explain why German investors, for example, buy Spanish Cédulas (average: 22%) with high yields while only a small number of Spanish investors buy low yielding German Pfandbriefe (average: 0.03%).

> FIGURE 3: PARTICIPATION RATE OF DOMESTIC INVESTORS IN TERMS OF COVERED BONDS IN THE RELEVANT NATIONAL CURRENCY



Source: market data, NORD/LB Fixed Income Research

Alongside the euro, other currencies are increasingly establishing themselves in the context of covered bond issues of an amount equivalent to around EUR 500m or higher. This is partly due to domestic issuers who use local currencies for funding purposes. Another group aims to expand its investor base by launching issues in foreign currency. In addition, advantageous swap rates can facilitate more favourable funding than in the relevant local currencies. Pound sterling and the Australian dollar have been established as important currencies for high-volume covered bond transactions in the past few years, alongside the US dollar. Furthermore, the Swiss franc, Danish krone, Swedish krona and Norwegian krone are highly important to local banks in terms of funding. However, the issues launched in these currencies usually have a comparatively low issue volume. A glance at the investor allocation relating to large-sized covered bonds shows that these securities are popular in currencies other than the euro. For example, the average participation rate among US and Canadian investors in issues denominated in US dollars was 61% in the period from January 2011 to April 2013. Other important regions of origin of investors who bought USD-denominated covered bonds included Europe (14%) and Asia (11%). The level of demand from domestic investors for covered bonds denominated in AUD was also above-average. Here, the average share amounted to 71%, with demand from other regions playing a secondary role. Local demand was even higher for issues denominated in GBP. The rate of participation of investors from the UK and Ireland in respect of these covered bonds was approximately 81% on average. In comparison, the rate of participation of investors from the eurozone in issues denominated in EUR was around 78%.

As the analysis demonstrates, there is no such thing as the classic covered bond investor. Investors are as diverse as issues are heterogeneous in terms of their maturities, spreads and other features, such as country of origin and currency. The challenge for issuers lies in reaching all relevant investors by appropriately addressing the target group and expanding their investor base on the basis of a scrupulous and transparent information policy.

ANNEX – THE COVERED BOND INVESTOR COUNCIL

By Annika Wahlberg, International Capital Market Association

In the past few years an intense and constructive cooperation among the covered bond stakeholders has distinguished this industry from others and has allowed the safeguard of the key macro-prudential characteristics of this asset class, which represent the basis for its regulatory recognition. Commitment to quality, transparency and liquidity are the overarching principles inspiring the activities of both the European Covered Bond Council (ECBC) and Covered Bond Investor Council (CBIC).

The cooperation between these two organisations has allowed the timely establishment of the ECBC's Covered Bond Label, fully operational since the 1st of January 2013, and the implementation of harmonised level of asset and liabilities disclosure at European level. Indeed, Covered bond issuers from 14 different jurisdictions have come together to develop a National Transparency Template providing cover pool information in a harmonised format on the basis of common guidelines agreed at European level. This chosen format allows for both the recognition of national specificities and the comparability of information required to facilitate investors' due diligence.

Moreover, this constructive dialogue and cooperation have triggered best practice market sharing and incentivised legislative improvements to the current covered bond frameworks.

The CBIC is a permanent working group of the Asset Management and Investors Council (AMIC). The CBIC meets regularly (and ad-hoc, via conference calls) to discuss broad industry issues. The CBIC offers the opportunity of physical meetings at its annual conference held in May as well as other key Covered Bond conferences (IMN London, ECBC/Euromoney, ECBC plenary meetings).

The International Capital Market Association (ICMA) established the Asset Management and Investors Council (AMIC) in 2008.

The AMIC:

> Discusses macro level industry and regulatory issues.

> Identifies and offers solutions to practical issues for members at a technical level.

> Proposes market-led initiatives in response to the challenges it has identified.

> Provides a coordinated response to the authorities, which is representative of the views of its cross-border membership from the international asset management and wealth management industry.

> Has established pro-active relationships with regulatory authorities at national, European and international level in a world where the regulatory authorities are increasingly moving from a national to an international remit.

> Works to ensure that authorities fully understand the consequences of any regulatory proposals for the asset management and wealth management industry.

> Establishes partnerships and actively works with other industry groups to ensure a coordinated approach. The AMIC has an inclusive and international perspective; it respects the work of the various national associations and specialist industry bodies, and works with them on specific topics.

DISTINCTIVE FEATURES OF THE CBIC

> Focus on national and cross-border issues that affect or could affect the international asset management and wealth management industry and institutional investors globally.

> The CBIC also provides investor information (written or verbally) on actual market topics which are related to Covered Bonds (Rating methodology changes, introduction of non-traditional Covered Bonds, regulatory decisions, etc).

> If agreed among the CBIC members, the CBIC opinion is forwarded to key market participants or associations e.g. ECB, EBA or to the EU Commission to strengthen the investor position.

> Membership open to all sectors of the industry who invest in covered bonds, including but not limited to: asset managers, fund managers, private banks, hedge funds, pension funds, insurance companies, treasuries/treasurers, institutional investors and sovereign wealth funds.

The CBIC has worked on enhancing transparency and facilitating easier comparison between covered bond programmes, and this has been and remains a priority for the CBIC. The information required has been agreed by members of the CBIC investor community, independently from the data requested by rating agencies and used in their analytical models. The CBIC believes that enhanced transparency of the cover pool helps the pricing process of covered bonds. The key concepts section of this transparency template also provides valuable information presented by issuers.

We welcome the publication of the national transparency templates, further to the creation of the ECBC's Covered Bond Label, and have invited national associations to use the CBIC transparency template as a framework when creating their own national transparency templates. The CBIC has communicated their views to the ECBC on the formation of the Covered Bond Label and welcomes the introduction of the label in 2013.

The CBIC also works on ensuring that the covered bond markets remain a liquid market and will continue to actively participate in debates on regulatory issues affecting the Covered Bond market.

CHAPTER 2 - GENERIC SECTION

2.1 OVERVIEW OF COVERED BONDS

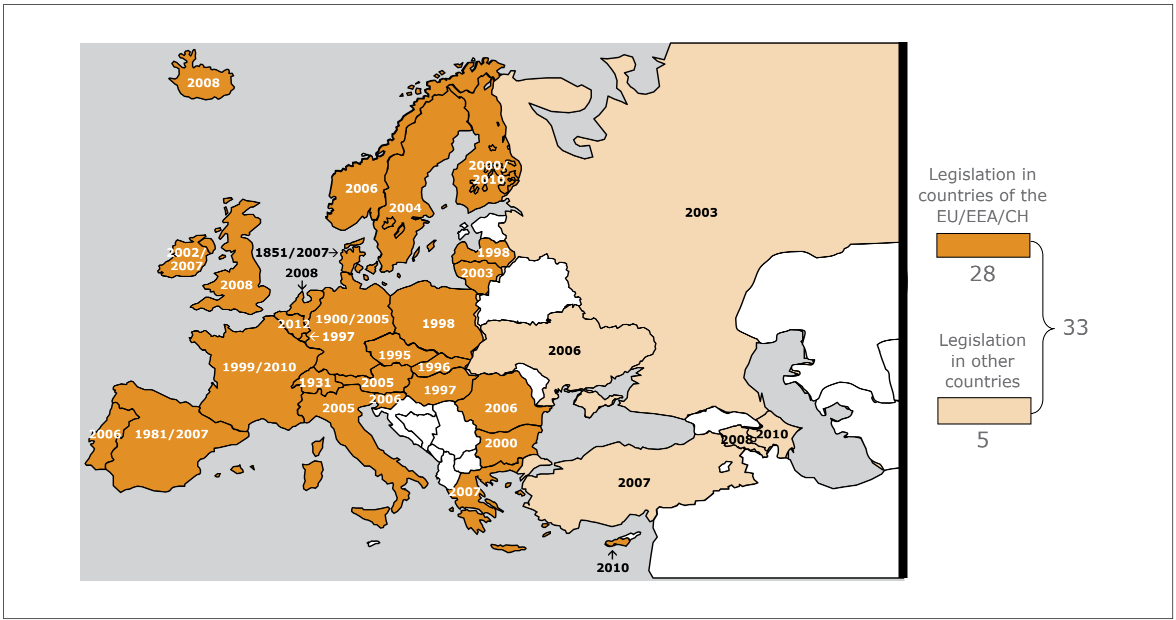
By Ralf Grossmann, Société Générale CIB
and Otmar Stöcker, Association of German Pfandbrief Banks

2.1.1 INTRODUCTION

Over the past 20 years, the covered bond market has developed into the most important segment of privately issued bonds on Europe's capital markets, with volume outstanding at the end of 2012 amounting to EUR 2.81 trillion[1]. Today, there are active covered bond markets (i.e. with issuance activity on a regular basis) in 26 different European countries (for more information, please refer to the covered bond statistics section in chapter 5). In addition, there are at least 7 European countries which have enacted or are in the process of updating or adopting covered bond legislation and are expected to launch active covered bond markets soon.

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

> FIGURE 1: COVERED BOND LEGISLATION IN EUROPE



Source: vdp

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

Covered bonds have proved their resilience as funding instrument at various occasions during the financial and sovereign crisis. It is generally accepted that the covered bond market should play a pivotal role in bank wholesale funding as it provides lenders with a cost-efficient instrument of long-term funding for mortgage or public-sector loans and offers investors the best possible quality of credit exposure on credit institutions. The high importance of covered bonds for the financial system is also demonstrated by the privileges these instruments enjoy in various areas of EU financial market regulation. As well as the introduction of new covered bond legislations, there has been a continuous evolution of existing legislation, underlining the commitment of issuers, investors and regulators to further reinforce the quality of the asset class and take on board best practice.

2.1.2 HISTORY

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

The creation and the expansion of covered bond systems in their different structures and features are a perfect example of a fruitful and effective exchange of ideas across all European borders. It is very impressive to see how the huge benefit of experience and exchange of international know how contributed to create the covered bonds in Europe during more than 240 years. In the 19th century, nearly every European country had a covered bond system. Their success influenced each other. Covered bonds also played an important role in stabilising financial systems at the end of the 19th century, a time of high bankruptcies of companies and banks.

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

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

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

2.1.3 THE PURPOSE OF COVERED BONDS

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

Cheap funding in absolute and relative terms and longer term funding

One of the key motivations for the introduction of a high quality funding tool such as covered bonds is the fact that it has always been difficult to measure the creditworthiness of a bank. Therefore, it is obvious to use a well-defined funding channel for specific assets through a system, whose credit quality is delinked as much as possible from the issuing entity. This is also mirrored in rating approaches where covered bond ratings generally benefit from a rating uplift of several notches over the unsecured rating of the issuing bank and certain delinkage in case of downgrades.

Larger investor base and larger investment volumes

Investors take particular comfort in covered bonds due to their safety features (legal frameworks, high quality assets, public supervision, etc...), offering higher recoveries and more transparency than a senior unsecured bank bond. The regulation around covered bonds (e.g. UCITS, CRD, Solvency II, lower ECB haircuts) reflects exactly those safety features and, in turn, allows more institutional investors to buy covered bonds and encourages them to engage themselves on a larger scale than in others products.

Market accessibility

Thanks to the high protection offered to its bond holders, covered bonds are one of the most resilient funding instruments during financial crisis, often offering issuers better wholesale capital market access and lower transaction execution risk than any other bank debt instruments. During the European sovereign crisis, it occurred that under certain conditions, over an extended period of time covered bond issuers had cheaper access to wholesale funding markets than their respective distressed sovereigns.

2.1.4 THE MACRO-ECONOMIC BENEFITS OF COVERED BONDS

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

Covered bonds also have an important role to play in the context of financial stability. In covered bonds, the issuer retains the credit risk of the underlying loans. This feature prevents the creation of those moral hazard problems which were one of the key factors of the 2008 subprime crisis in securitisation markets. Moreover, covered bonds are the most reliable funding source as they make banks less susceptible to adverse market conditions decreasing the reliance on senior unsecured funding and interbank markets. On the back of the severe market turmoil 2008-2010, the ECB acknowledged the prominent role of covered bonds and stated in January 2011: "A smoothly functioning covered bond market is highly important in the context of financial stability."[2]

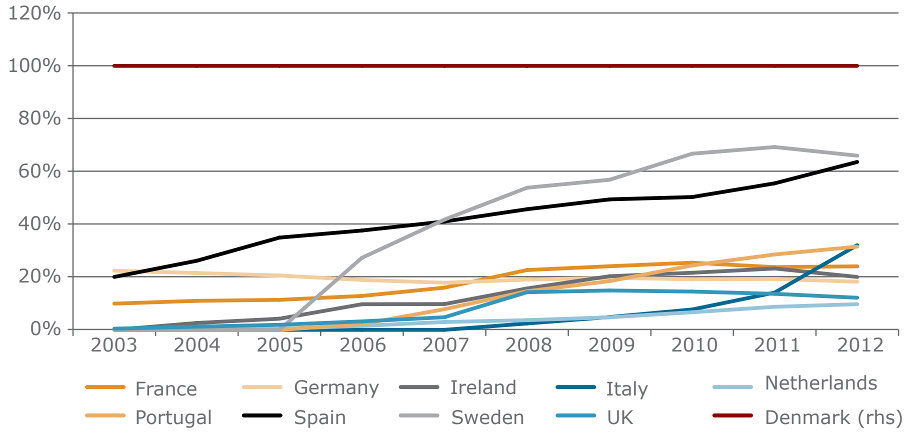
However, as the crisis continued and covered bond issuance exceeded the issuance of senior unsecured bonds in the EUR market for the first time ever, asset encumbrance became a major topic in the financial stability debate. There are concerns that a high amount of bank assets, which are pledged to special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

2 See: The impact of the Eurosystem's covered bond purchase Programme on the primary and secondary Markets; Occasional Paper series, No 122 /January 2011, page 9.

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

The substantial macro-economic benefits of covered bonds have to be taken into account for the design of future banking regulation. It is evident that covered bonds will not be able to fulfil their important role in the context of financial stability if the product would not be fully and properly exempted from bail-in regulation or if a hard-limit for covered bond issuance would be set in a regulation targeted to limit asset encumbrance.

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

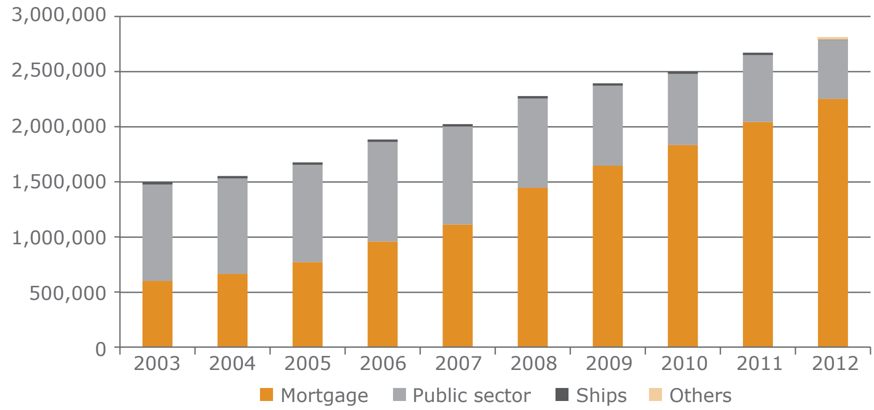


Source: EMF/ECBC

2.1.5 MORTGAGE – PUBLIC SECTOR - SHIP

The major categories of cover assets are mortgage loans, public sector loans and ship loans. The range of eligible cover assets is defined by a country's covered bond system. Covered bonds backed by mortgage loans exist in all countries with covered bond systems. Covered bonds to fund public sector lending (to national, regional and local authorities) are issued on a regular basis only in a limited number of European countries (Austria, France, Germany, Luxembourg, Norway, Spain and UK). Covered bonds backed by ship loans are rarer but can be found in Denmark and Germany. 2012 has seen first issuance of German Pfandbriefe backed by aircraft loans.

> FIGURE 3: TOTAL OUTSTANDING COVERED BONDS BY UNDERLYING ASSETS, 2003 TO 2012



Source: EMF/ECBC - Covered bonds outstanding at the end of 2012.

2.1.6 COMPARATIVE COVERED BOND FRAMEWORK DATABASE

The ECBC website presents in an on-line database at www.ecbc.eu a comparative analysis, based on a questionnaire with the responses of 40 frameworks. The comparative overview is divided into 9 sections covering the essential features of covered bond systems. In addition, links are provided to the covered bond section of all issuers' websites, as well as covered bond legislation in English. Here, we highlight some of the results of that comparative overview.

Structure of the issuer

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

- Universal credit institutions
- Universal credit institutions with a special license
- Specialised credit institutions
- Special purpose entities

Framework

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

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

Cover assets

The eligible cover assets in existing European covered bond systems range from exposures to public sector entities, mortgage and housing loans, exposures to credit institutions, senior MBS issued by securitisation entities to ship and aircraft loans. Some covered bond systems distinguish between regular cover assets (usually mortgage, housing, public sector, ship loans and senior MBS) and substitution assets, where the latter is often subject to quantitative restrictions.

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

Valuation of mortgage cover pool & LTV criteria

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 ranging for residential mortgage loans from 60% to 80%. In some countries, there are additional LTV limits on a portfolio basis.

Asset-liability guidelines

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

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

Cover pool monitor & banking supervision

Most covered bond systems have established an external, independent cover pool monitor who must have appropriate qualifications. Moreover, in most countries national banking supervisors (and in some cases, financial market regulators) exercise special supervision of covered bonds.

Segregation of assets & bankruptcy remoteness

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

Numerous covered bond systems have provisions that allow derivatives to become part of the cover pool with the purpose to hedge interest rate or currency mismatches. Derivative counterparties can rank *pari passu* or subordinated to covered bondholders. In covered bond systems, covered bondholders have recourse to the issuer's insolvency estate upon a cover pool default (*pari passu* with unsecured creditors or even superior to them).

Risk weighting & compliance with European legislation

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

2.1.7 SUCCESS OF THE INSTRUMENT

The covered bond is one of the key components of European capital markets. The amount of outstanding mortgage covered bonds is equivalent to around 20% of outstanding residential mortgage loans in the EU. The volume outstanding at the end of 2012 amounted to 2.81 trillion EUR (covered bonds covered by mortgage loans, public-sector loans and ship loans), which represents an increase of 5,2% year on year. The five largest issuing countries in 2012 were Germany, Spain, Denmark, France and Sweden respectively.

Covered bonds play an important role in the financial system and thereby contribute to the efficient allocation of capital and ultimately economic development and prosperity. The importance of covered bonds is also evidenced by the broad variety of different bond formats and currencies under which the product is issued and by the large investor base. Both subjects are addressed in the key themes section.

> Figure 4: Volume outstanding CB in Europe end of 2012 in EUR million

	Public Sector	Mortgage	Ships	Others	Mixed Assets	Total
Australia	0	34,902	0	0	0	34,902
Austria	25,831	17,010	0	0	0	42,841
Belgium	0	2,590	0	0	0	2,590
Canada	0	49,121	0	0	0	49,121
Cyprus	0	4,550	0	0	0	4,550
Czech Republic	0	9,056	0	0	0	9,056
Denmark	0	359,560	6,325	0	0	365,885
Finland	0	26,684	0	0	0	26,684
France	72,033	208,297	0	0	81,560	361,890
Germany	301,125	215,999	7,246	506	0	524,876
Greece	0	18,046	0	0	0	18,046
Hungary	0	4,958	0	0	0	4,958
Iceland	0	893	0	0	0	893
Ireland	27,546	25,099	0	0	0	52,645
Italy	10,300	116,405	0	0	0	126,705
Latvia	0	0	0	0	0	0
Luxembourg	24,859	0	0	0	0	24,859
Netherlands	0	61,515	0	0	0	61,515
New Zealand	0	6,741	0	0	0	6,741
Norway	2,742	107,462	0	0	0	110,205
Panama	0	152	0	0	0	152
Poland	110	657	0	0	0	768
Portugal	1,300	34,570	0	0	0	35,870
Slovakia	0	3,835	0	0	0	3,835
South Korea	0	2,407	0	0	0	2,407
Spain	33,609	406,736	0	0	0	440,345
Sweden	0	220,374	0	0	0	220,374
Switzerland	0	85,714	0	0	0	85,714
United Kingdom	3,742	185,243	0	0	0	188,985
United States	0	6,000	0	0	0	6,000
EU-27	**500,455**	**1,927,926**	**13,571**	**506**	**81,560**	**2,524,018**
Total	**503,197**	**2,214,577**	**13,571**	**506**	**81,560**	**2,813,411**

Source: EMF/ECBC

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

2.1.8 WHO INVESTS ON COVERED BONDS

Anne Caris, Bank of America Merrill Lynch

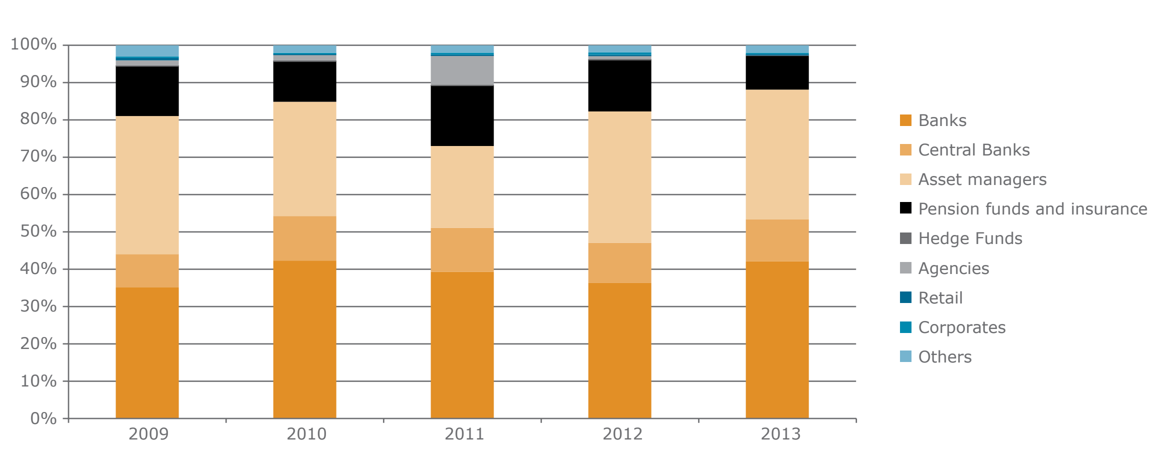
Through the crisis, covered bonds have reaffirmed their good track record from a number of key angles: 1/ less market volatility compared with sovereign or bank senior unsecured debt; 2/ better rating stability, although they were not immune from downgrades given their link to sovereign and bank ratings; 3/ the security provided by their cover pools, which are increasingly domestic residential mortgages (although national differences are evident); 4/ regulatory support from the ECB Covered Bond Programme II or their preferential treatment, notably in regulations such as European Central Bank (ECB) repo eligibility, BIS capital charges, Basel 3 Liquidity Coverage Ratio, Solvency II, bank bail-in/resolution. As a result, covered bonds have attracted a widening range of investors by type and across countries.

Banks and central banks remain major investors (see Figure 5) focusing, especially since last summer, on the less volatile and highly rated names for liquidity purposes or to meet regulatory criteria. Asset managers tend to prioritise yields/performance versus their benchmarks and, thus, have been less restricted in terms of issuer names/geographical markets depending on their internal limits (rating, counterparty, etc). Life insurers and pension funds are active, especially in the longer maturities for Asset and Liability Management (ALM) reasons, being typically buy-to-hold investors. The presence of hedge funds in the primary market in a few instances since end-2012 illustrates the hybrid characteristics of covered bonds (which are traded as rates and credit products) and their relative attractiveness versus some other debt instruments.

Investors are active in covered bonds across Europe, but Germans/Austrians remain somewhat dominant (see Figure 6). The lack of (domestic) supply, especially since 2012, has led to more cross-border diversification, thus reducing the domestic bias of the past. This has enhanced the depth of some markets. Asian investors have also been more active, especially since the start of 2013, although not across deals – more on an opportunistic basis. The successful penetration of new non-European banks (e.g., Australian/New Zealand) and their regular issuance has contributed to the widening of the investor base in the EUR-benchmark covered bond market.

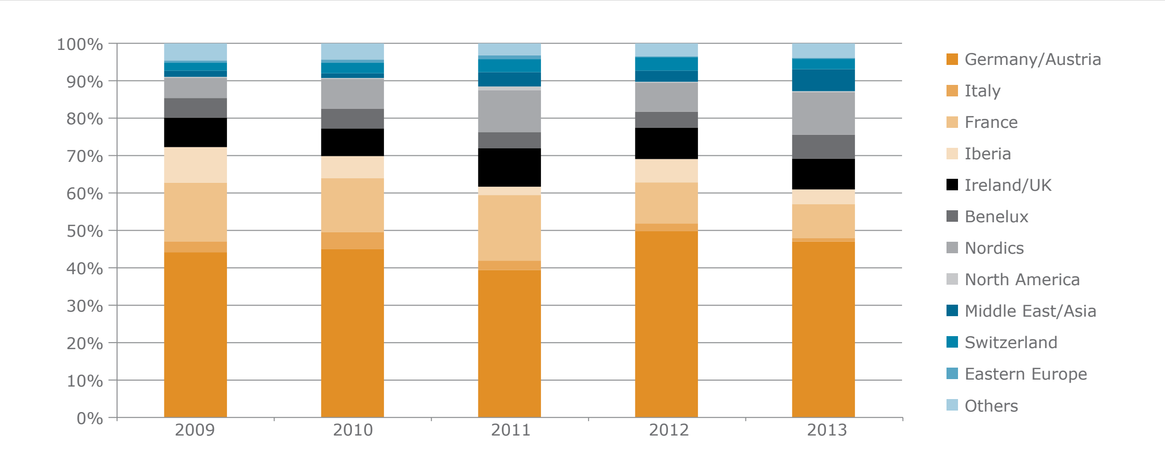
While investors are increasingly crossing, this has not translated into a conflict of interest. Data show that the investor base across debt instruments is still complementary. This is obvious when comparing senior unsecured debt with covered bonds, for example, with a lower participation of banks and central banks and better geographical diversification in the former (see Figure 7 and Figure 8). The USD-benchmark covered bond market also offers a different investor profile – both by geography and investor type – emphasising its strategic importance in terms of investor reach including for European issuers (see Figure 9 and Figure 10).

> FIGURE 5: ALLOCATION OF EUR-BENCHMARK ISSUANCE BY INVESTOR TYPE – COVERED BOND MARKET



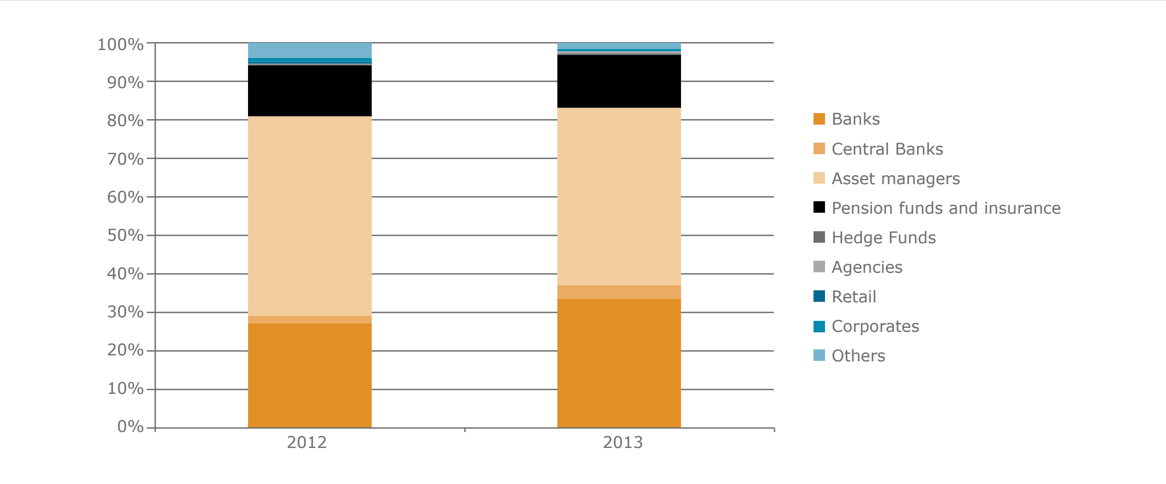
Source: Bloomberg, The Cover

> FIGURE 6: ALLOCATION OF EUR-BENCHMARK ISSUANCE BY COUNTRY – COVERED BOND MARKET



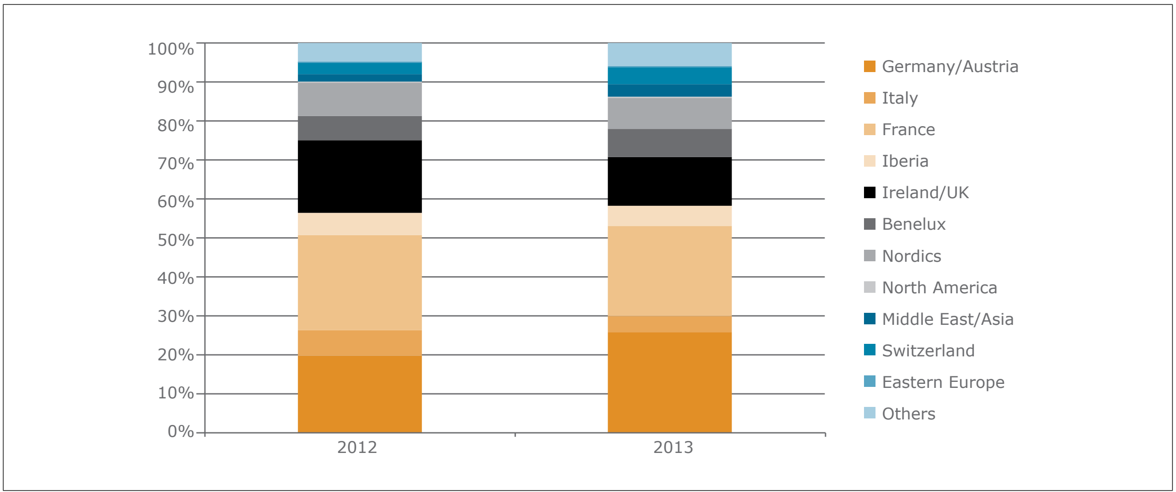
Source: Bloomberg, The Cover

> Figure 7: Allocation of EUR-benchmark issuance by investor type – senior unsecured market



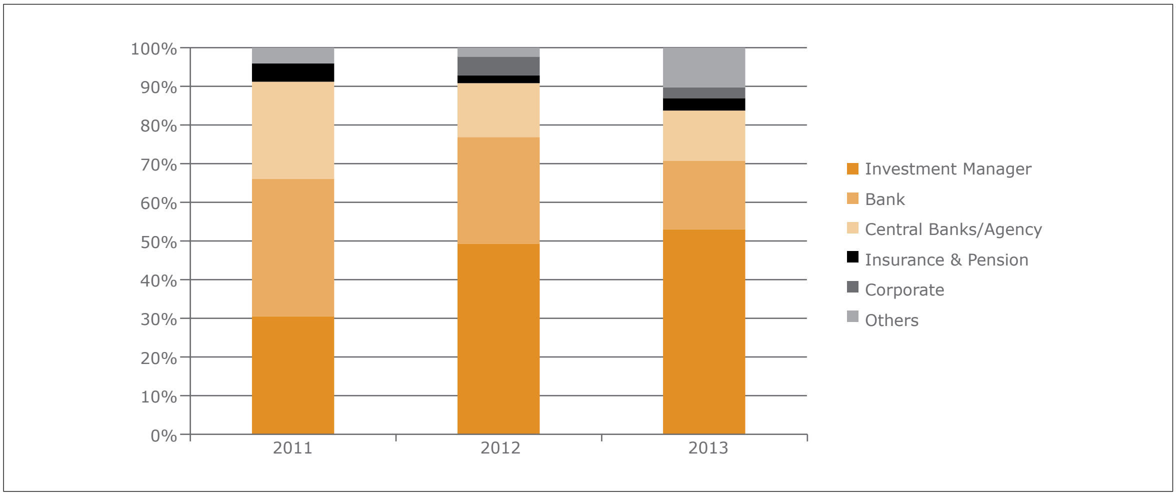
Source: Bloomberg

> Figure 8: Allocation of EUR-benchmark issuance by country – senior unsecured market



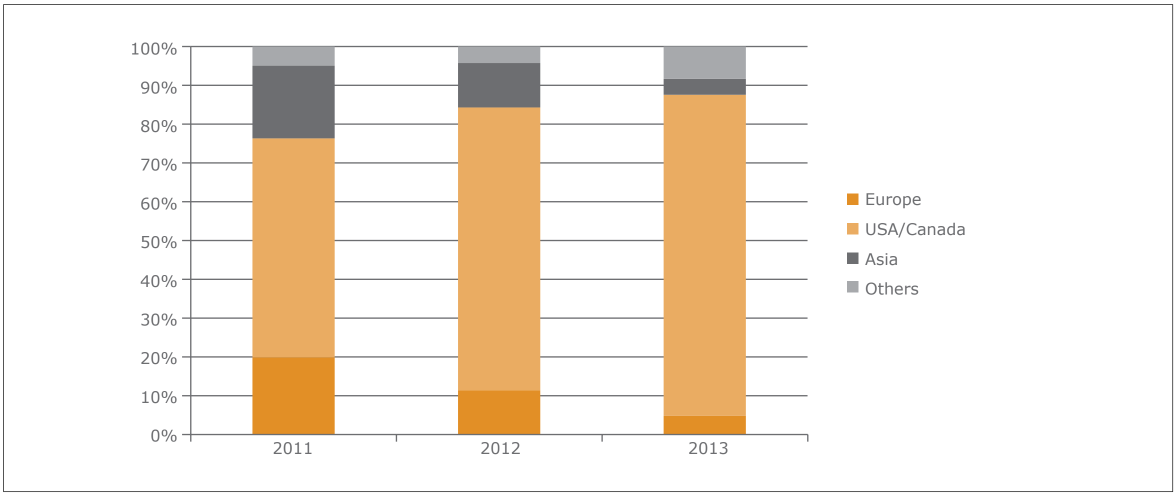
Source: Bloomberg

> FIGURE 9: ALLOCATION OF US$-BENCHMARK ISSUANCE BY INVESTOR TYPE – COVERED BOND MARKET



Source: Bloomberg, IFR

> FIGURE 10: ALLOCATION OF US$-BENCHMARK ISSUANCE BY COUNTRY – COVERED BOND MARKET



Source: Bloomberg, IFR

2.2 REGULATORY ISSUES

2.2.1 COVERED BONDS AND EU BANKING REGULATIONS

By Fritz Engelhard, Barclays Capital

The regulatory landscape continues to evolve, which means that investors and issuers need to keep an eye on future regulatory changes when making decisions. This chapter provides an overview of the capital requirements for covered bonds under EU regulations for credit institutions. It also describes the treatment of covered bonds under liquidity risk management rules.

With the endorsement of the new liquidity standard by the Basel Group of Governors and Heads of Supervision (GHOS) in January 2013, EU authorities could proceed with the implementation of Basel III rules. Following the so-called "trialogue" negotiations between the European Commission, Parliament and Council, in April 2013 the European Parliament adopted the new directive[1], governing access to deposit-taking activities, and the Capital Requirements Regulation (CRR)[2], which establishes prudential requirements for all EU banks. The final texts (Regulation[3] and Directive[4]) were published in Official Journal on 27 June 2013.The respective rules will become effective from 1 January 2014.

The foundations for the prudential rules on capital and liquidity requirements are set in the directive in Title VII (Prudential supervision), Chapter 2 (Review Processes), Section II (Arrangements, processes and mechanisms of institutions), Sub-Section 2 (Technical criteria concerning the organisation and treatment of risks). Article 79 of Sub-Section 2 assigns the duty to "competent authorities" to ensure that credit institutions have appropriate credit and counterparty risk management rules in place. Article 86 of Sub Section 2 obliges "competent authorities" to put measures for appropriate liquidity risk management in place and article 87 addresses the "risk of excessive leverage".

The detailed rules on capital requirements and liquidity risk management are not part of the directive, but part of the CRR, which banks throughout the EU must respect. Member states will be allowed to apply stricter requirements only when these are: 1) justified by national circumstances; 2) needed to maintain financial stability; or 3) necessary because of a bank's specific risk profile. The regulation consists of eleven parts and five annexes. For the introduction of minimum capital requirements and the LCR, the CRR applies a similar phase-in schedule as proposed under Basel III, but the main difference is that the minimum level of 100% LCR must be achieved one year earlier, on 1 January 2018. The submission date for a proposal of EU-wide NSFR rules is 31 December 2016.

DEFINING COVERED BONDS

In the CRR, the definition of covered bonds is stipulated in Part Three (Capital requirements), Title II (Capital requirements for credit risk), Chapter 2 (Standardised approach), Section 2 (Risk weights) under article 129. It almost mirrors the definition of covered bonds under the previously relevant capital requirements directive. An important difference is the inclusion of French home loans in the definition of eligible cover pool assets. Furthermore, qualification for beneficial treatment has been made subject to due diligence requirements imposed on banks investing in covered bonds. One minor difference lies in the fact that national regulators will have the discretion to allow the inclusion of substitute assets rated single-A (qualifying for "credit quality step 2") of up 10% of the total outstanding covered bonds where the limitation to exposures qualifying for credit quality step 1 would prevent adequate diversification.

1 Adopted text: TA(2013)0114
2 Adopted text TA(2013)0115
3 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0001:0337:EN:PDF
4 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0338:0436:EN:PDF

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

> The covered bond must be issued by an EU credit institution.

> The credit institution must be subject to special public supervision by virtue of legal provisions protecting the holders of the bonds.

> The investment of issuing proceeds may be effected in eligible assets only; the eligibility criteria are set by law.

> Bondholders' claims on the issuer must be fully secured by eligible assets until maturity.

> Bondholders must have a preferential claim on a subset of the issuer's assets in case of issuer default.

Beyond these more formal rules, a series of eligibility criteria for cover assets are stipulated. The eligibility criteria set a 10% limit for the use of RMBS and CMBS notes and allow a full or partial use of RMBS and CMBS notes only until 31 December 2017 and only in cases where the underlying mortgages were originated within the same consolidated banking group, where a member of the same banking group holds the first loss tranche and where the notes are at least rated AA-.

According to the adopted criteria, the asset pool of a covered bond may include the following:

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

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

c) Substitute assets from credit institutions with a minimum rating of AA-. The total exposure of this kind shall not exceed 15% of the nominal amount of outstanding covered bonds; subject to consultation with the EBA, authorities might allow the inclusion of substitute assets rated at least -A of up 10% of the total outstanding covered bonds where the limitation to exposures qualifying for a minimum rating of AA- would prevent adequate diversification; exposures caused by transmission and management of payments of the obligors of, or liquidation proceeds in respect of, loans secured by immovable property to the holders of covered bonds shall not be comprised by the 15% limit; exposures to institutions in the EU with a maturity not exceeding 100 days shall not be comprised by the AA- rating requirement, but those institutions must as a minimum qualify for an A- rating.

d) Loans secured by residential property up to an LTV of 80% or by senior RMBS notes issued by securitisation entities governed by the laws of a Member State, provided that the relevant supervisory authorities ensure that at least 90% of the assets of such securitisation entities are composed of mortgages up to an LTV of 80% and the notes are rated at least AA- and do not exceed 10% of the nominal amount of the outstanding issue.

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

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

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

The use of "immovable property" as collateral for covered bond assets is restricted and must meet specific legal and valuation requirements set out in articles 208 and 229 of the CRR. The legal requirements include: the enforceability of the mortgage charge; the ability to realize the security value of the protection within a reasonable timeframe; and adequate insurance against risk of damage. The valuation requirements stipulate that properties should be valued by an independent valuer and be documented in a transparent and clear manner.

In order to qualify for preferential treatment under capital requirement rules, credit institutions investing in covered bonds are required to undertake due diligence on their respective products. The credit institutions need to demonstrate to the regulators that they receive portfolio information on: 1) the value of the cover pool and outstanding covered bonds; 2) the geographical distribution and type of cover assets, loan size, interest rate and currency risks; 3) the maturity structure of cover assets and covered bonds, and 4) the percentage of loans more than ninety days past due. Furthermore, according to article 129 (7a) (b), covered bonds would qualify for beneficial treatment only when the issuer makes the above information available to the credit institution investing in covered bonds on a semi-annual basis. In my view, the inclusion of these due diligence requirements exposes investors to substantial risk, as fulfilling them depends on the willingness and ability of covered bond issuers to meet the respective criteria, which might both be weakened in a wind-down situation.

In article 503, the future risk weight for covered bond holdings is made dependent on meeting additional criteria, including an adequate quality differentiation between covered bonds, adequate transparency of the covered bond market and the extent of asset encumbrance. In the same article, the additional use of loans secured by aircrafts and the derogation rules for covered bonds backed by RMBS or CMBS notes are subject to review periods until YE 2014 (aircraft loans) and YE 2016 (derogation) respectively.

ASSIGNMENT OF RISK WEIGHTINGS

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

Compared to CRD III, the major change in the articles of the CRR regulating the risk weighting of covered bonds is that the calculation of the risk weighting of covered bonds within the standard approach is now directly linked to the covered bond rating and not to the rating of the issuer or sponsor bank. Figure 4 shows that a risk weighting of 10% will apply where the covered bonds are rated at least AA-/Aa3 and a risk weighting of 20% will apply where the covered bonds are rated between BBB-/Baa3 and A+/A1. This compares with risk weightings of 20% and 50%, respectively, for similarly rated senior bonds issued by banks.

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

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

Note: Mapping based on FSA rules

Source: European Commission, FSA, Barclays Capital

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

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

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

Note: Mapping based on FSA rules

Source: European Commission, FSA, Barclays Capital

Contrary to the standardised approach, an explicit direct link to the covered bond rating is missing in the IRBA. Thus, for banks using the IRBA and the advanced IRBA, the starting point for assessing the risk weighting of covered bonds will still be the probability of default of the issuer or sponsor bank, which generally is correlated to its senior unsecured rating.

Under the IRBA credit institutions can determine their capital requirements on the basis of internally generated estimates of the risk of loss on their assets. These estimates require inputs relating to the one-year probability of default (PD), the loss given default (LGD), the exposure at default (EAD) and the effective maturity (M), which are combined to give capital requirements and risk weightings. The relevant measures are stipulated in Part Three (Capital requirements), Title II (Capital requirements for credit risk), Chapter 3 (Internal ratings based approach), section 4 (PD, LGD, and Maturity).

The CRR provides a specific framework for calculating internal ratings-based risk weights for covered bonds. (non-EU based banks applying the Basel framework to covered bonds would have to treat them as senior bank debt.) The EU regulation specifies constraints on risk components as follows:

> PD (which relates to issuer rather than issue default risk) must be at least 0.03% (article 160).

> LGD should be assigned a value of 11.25%. This is stipulated in article 157. For banks applying the advanced approach, a lower LGD is possible. Historical data for residential mortgage assets underline that LGD levels are basically below 10%.

> M, the effective maturity of the bond, is limited to a range of one to five years in case banks apply the advanced approach. For the foundation approach, the regulations specify an effective maturity of 2.5 years for all bonds (article 162).

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

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

Figure 3: Rating agency cumulative one-year default rates (%)

	S&P (1981-2010)	Moody's (1983-2010)	Fitch (1991-2010)
AAA/Aaa	0.00	0.00	0.00
AA/Aa	0.02	0.02	0.04
A/A	0.08	0.06	0.24
BBB/Baa	0.25	0.20	0.58
BB/Ba	0.95	1.20	1.28

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

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

Figure 4 provides an illustrative matrix of risk weightings based on plugging a range of different default probabilities and the average life figures in the respective functions.

Figure 4: Risk weighted asset ratios (%) for different default probabilities and average lives (LGD = 11.25% in all cases)

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

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

Source: Barclays Capital.

The 0.03% floor for PD is likely to be applied by most risk models, at least down to banks rated at the bottom of the AA range. For covered bonds issued by banks in this top category, the risk weighting will range from 2.0% to 6.9% depending on maturity. This represents a significant capital saving relative to the risk weightings under the standard approach. It also highlights that in the IRBA, the risk weighting is significantly affected by the remaining life of the bond, which is not the case in the standard approach. Banks applying the IRBA will have a significant incentive in terms of capital utilisation to invest in shorter maturities.

LIQUIDITY RISK FRAMEWORK

In the CRR, the regulations for the use of securities as liquidity buffer investments are stipulated in Part six (Liquidity) in articles 415, 416, 417, 418 and in Part ten (Transitional provisions, reports and reviews) in article 509. The overall liquidity buffer portfolio is divided into a (level 1) bucket of assets, which qualify for an "extremely high liquidity and credit quality", and a (level 2) bucket of assets with "high liquidity and credit quality".

Level 2 assets are subject to a 15% haircut. The limit on Level 2 assets to 40% of the total liquidity buffer is not applicable to the final CRR. Initially, this was stipulated in article 405 under the rules for "operational requirements". However, according to article 509(1) c, until 31 December 2013, EBA will propose a method restricting the use of certain categories of liquid assets to cover liquidity requirements and test a minimum threshold of 60% for Level 1 assets, taking into account "international regulatory developments". Such a 60% minimum threshold for Level 1 assets would effectively limit the use of Level 2 assets to a maximum of 40%. Furthermore, according to article 509(5), until 31 January 2014, EBA shall report on the operational requirements for holdings of liquid assets in line with "international regulatory requirements". As Basel III rules stipulate a 40% limit on Level 2 assets, eventually the EU will not have enough room to deviate from this guideline.

Those covered bonds that are only compliant with article 52(4) of Directive 2009/65/EC, but not with the enhanced collateral criteria of article 129 of the CRR, may also qualify for the liquidity buffer. In addition, the use of asset backed securities has been included in the list of assets explicitly eligible for HQLA portfolios. However, the application of this broader definition of liquid assets is unclear. This is because article 415 also refers to "Annex III", which contains a narrower set of rules, specifically excluding SSPEs again.

According to article 509(3), after consulting ESMA and the ECB, EBA has the mandate to develop "appropriate uniform" definitions of HQLA. In this process, it shall "test the adequacy of the following criteria and the appropriate levels for such definitions: (1) minimum trade volume; (2) minimum outstanding volume; (3) transparent pricing and post-trade information; (4) credit quality steps; (5) proven record of price stability; (6) average volume traded and average trade size; (7) maximum bid/ask spread; (8) remaining time to maturity; and (9) minimum turnover ratio". The EBA report, due on 31 December 2013, should also consider other categories of assets, including central bank eligible loans, local government bonds, commercial paper, gold, listed equities, index-linked equity instruments, guaranteed bonds, corporate bonds, non-central bank eligible covered bonds, and funds based on such assets. Cash, government bonds, supranational debt, as well as RGLA and PSE exposures, are explicitly exempt from the adequacy test. Furthermore, EBA should report by 31 January 2014, on whether the definition of liquid assets has had unintended consequences on monetary policy operations.

Under recital 100 lawmakers highlight that "when making a uniform definition of liquid assets at least government bonds, and covered bonds traded on transparent markets with an ongoing turnover would be expected to be considered assets of extremely high liquidity and credit quality."

Another important amendment particularly relevant for covered bond issuers refers to the general rules of liquidity management and leverage. Article 509(1) obliges the EBA to monitor and report on all those cases where the application of liquidity requirement regulations will have a "material detrimental impact on the business and risk profile of European Union institutions, or on the stability and orderly functioning of financial markets or on the economy and the stability of the supply of bank lending". This wording may allow authorities to amend certain liquidity management rules for countries with a significant presence of specialized credit institutions.

Finally, final decisions will be made only after prolonged testing periods. In this respect, ample powers were assigned to the EBA to make proposals for appropriate definitions and monitor the impact of the application of liquidity rules. In particular, it should also work on the "definition of circumstances of stress, including principles for the use of the stock of liquid assets and the necessary supervisory reactions under which institutions would be able to use their liquid assets to meet liquidity outflows and how to address non-compliance". With regards to maintenance of liquidity ratios and buffers, the EBA shall report by end of 2013 on adequate definitions for HQLA. By 31 December 2015 it should make a proposal on adequate liquidity management rules and "if appropriate", by 31 December 2016, the EU should submit a legislative proposal to the European Parliament and Council.

2.2.2 SOLVENCY II UPDATE – NOT MUCH NEW COMPARED TO LAST YEAR, ONLY TIME FRAME BACKWARDS ONCE MORE...

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

Solvency II is one of those regulatory proposals that just keeps dragging on for ever and ever. There is at this point still no political agreement on Omnibus II via which Solvency II rules would be implemented and since there has been no further quantitative impact study (QIS), the details and technical specifications from QIS 5 are still valid. As a result of this and the ongoing delay, the European Insurance and Occupational Pensions Authority (EIOPA) fears that individual member states could opt for national rules which would lead to a very heterogeneous regulatory landscape in the insurance sector and make a Solvency II implementation at a later point even more difficult. Because of this EIOPA published a consultation paper in March that tries to harmonise at least the preparatory work done by European member states on Solvency II. These harmonised guidelines should come in force on 1st January 2014. The most recent start date for the overall Solvency II rules that has been discussed is 2016 at this point.

Apart from timing issues there have been no fundamental changes to Solvency rules in the last 12 months. Consequently the planned treatment of covered bonds under Solvency II is still the same as it was last year. There have been some discussions over the treatment of securitisation assets as regulators seem to start to think that the product has been treated too harshly and not differentiated enough in QIS 5. There are no concrete proposals yet though. So compared to last year, the main changes to Solvency II at this point have been on the timing of the implementation.

Below we want to give everyone a heads up on the status quo with regards to covered bonds.

CAPITAL CHARGES IN THE SPREAD RISK MODULE

The spread risk module is one of the biggest drivers of capital charges under Solvency II. In QIS 5 there were two problems for covered bonds:

> Covered bonds only received beneficial treatment as long as they were rated AAA. A downgrade to AA+ meant they were treated like senior unsecured exposure with capital charges almost doubling.

> There was a linear relationship between duration and capital charges making it less attractive for insurance companies to invest at the long end.

> The most recent Solvency II proposal addresses both problems:

> A separate category for AA+ to AA- rated covered bonds was created, which has a 0.9% capital charge per year of duration.

> The linear relationship between duration and capital charge was broken up after five years with capital charges for covered bonds going up by 0.5% for every year of duration after that.

Figure 1: An overview of capital charges for covered bonds other asset classes (%) per year of duration under the current proposal vs. the QIS 5 results (as indicated in brackets)

Product	Up to 5 years	5 to 10 years	1	2	3	4	5	6	7	8	9	10
AAA covered	0.7%* dur.	3.5% + 0.5%* (dur. -5)	0.7 (0.6)	1.4 (1.2)	2.1 (1.8)	2.8 (2.4)	3.5 (3.0)	4.0 (3.6)	4.5 (4.2)	5.0 (4.8)	5.5 (5.4)	6.0 (6.0)
AA + to AA- covered	0.9%* dur.	4.5% + 0.5%* (dur. -5)	0.9 (1.1)	1.8 (2.2)	2.7 (3.3)	3.6 (4.4)	4.5 (5.5)	5.0 (6.6)	5.5 (7.7)	6.0 (8.8)	6.5 (9.9)	7.0 (11.0)
A+ to A- covered	1.4%* dur.	7% + 0.7% * (dur. -5)	1.4 (1.4)	2.8 (2.8)	4.2 (4.2)	5.6 (5.6)	7.0 (7.0)	7.7 (8.4)	8.4 (9.8)	9.1 (11.2)	9.8 (12.6)	10.5 (14.0)
AAA to AA- sovereign	0,0%	0,0%	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)
A+ to A- sovereign	1.1%* dur.	5.5% + 0.58* (dur. -5)	1.1 (1.1)	2.2 (2.2)	3.3 (3.3)	4.4 (4.4)	5.5 (5.5)	6.1 (6.6)	6.7 (7.7)	7.2 (8.2)	7.8 (9.9)	8.4 (11.0)
AAA corpo-rate	0.9%* dur.	4.5% + 0.53%* (dur. -5)	0.9 (0.9)	1.8 (1.8)	2.7 (2.7)	3.6 (3.6)	4.5 (4.5)	5.0 (5.4)	5.6 (6.3)	6.1 (7.2)	6.6 (8.1)	7.2 (9.0)
AA+ to AA- corporate	1.1%* dur.	5.5% + 0.58%* (dur. -5)	1.1 (1.1)	2.2 (2.2)	3.3 (3.3)	4.4 (4.4)	5.5 (5.5)	6.1 (6.6)	6.7 (7.7)	7.2 (8.8)	7.8 (9.9)	8.4 (11.0)
A+ to A- corporate	1.4%* dur.	7% + 0.7% * (dur. -5)	1.4 (1.4)	2.8 (2.8)	4.2 (4.2)	5.6 (5.6)	7.0 (7.0)	7.7 (8.4)	8.4 (9.8)	9.1 (11.2)	9.8 (12.6)	10.5 (14.0)
AAA secu-ritisation	7%* dur.		7	14	21	28	35	42	42	42	42	42
AA securiti-sation	16%* dur.		16	32	48	64	80	80	80	80	80	80

* values in brackets are from QIS 5

The big winners in the 2011 proposal compared to QIS 5 were AA rated covered bonds. Their capital charge, especially for the longer dated maturities, dropped considerably. First of all the starting point is not 1.1% any-more, as was the case under QIS 5, but 0.9% and the subsequent increases after year five are significantly smaller. For a 10 year AA rated covered bond the capital charge is about 4% less at 7%.

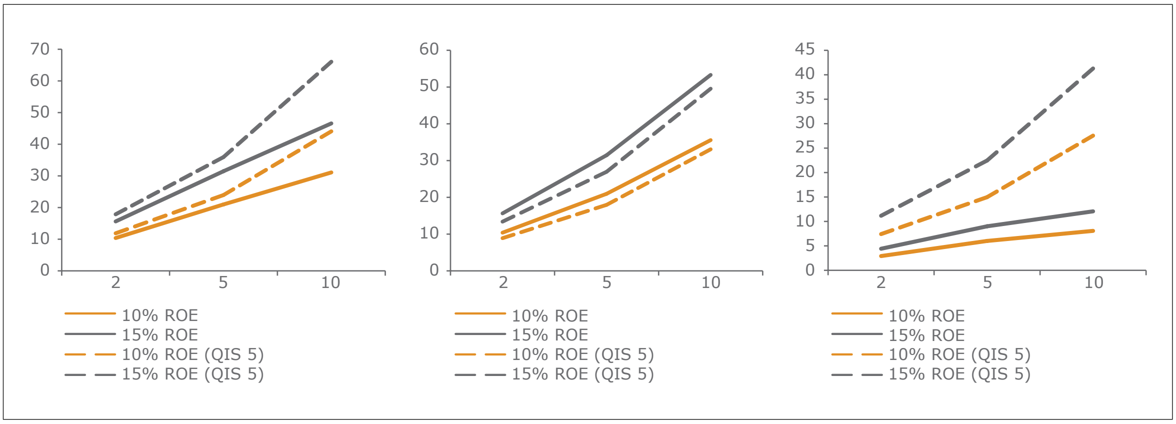
To compensate for the improved AA rated covered bonds treatment, the capital charge for AAA rated covered bonds went up slightly from 0.6% to 0.7%. The aggregate effect after taking into account the different duration treatment was minimal though.

All of these changes have a number of consequences on relative capital charges, and therefore on required spread differences between covered bonds and other products.

As a result of the slightly higher capital charge, AAA rated covered bonds did lose a little bit of their edge over senior unsecured bonds and the capital charge difference to highly rated sovereign bonds increased slightly. The 2011 rules had the biggest positive impact on AA rated covered bonds though.

In the past it had been a major concern to see a downgrade from AAA to AA+ as capital charges would have gone up significantly. For an insurance company which has an internal required rate of return on capital of 15%, the required spread difference in the ten year segment used to be 41bp. This figure has come down to a mere 12bp after the 2011 changes. In the five year segment, the difference went from 23bp to only 9bp.

> Figures 2, 3 and 4: Spread needed to compensate for additional capital between AAA rated covered bonds and ...
...A rated senior unsecured (bp) ...AAA rated sovereign (bp) ...AA rated covered bonds (bp)



Source: EU, Crédit Agricole CIB

When looking at the comparison between covered bonds and RMBS one thing becomes apparent:

> Securitisations are still the big loser of Solvency II and even the 2011 proposal did not do much to address this.

> Capital charges for 5Y AAA covered bonds are only 1/10 of these for AAA rated securitisations (3.5% vs 35%). AA rated 5Y covered bonds have a little more than 1/20 the capital charge than an AA rated securitisation (4.5% vs 80%).

Capital charges for securitised assets in Solvency II were modelled based on US subprime RMBS. This treatment was equally applied to Dutch or UK prime RMBS as well as to the US subprime securitisation tranches. There was no differentiation between various countries' products irrespective of their actual quality. Since then, the securitisation product has however started to stage a mini comeback when it comes to its regulatory treatment. There is nothing feasible yet, but there have been many discussions about the long term refinancing of the European economy lately and securitisation is starting to play a role again in those discussions. Even the ECB is thinking about how it can support for example lending to the SME sector via ABS.

These discussions are however still at an early stage and for now, especially in the residential mortgage sector we would expect insurance companies to maintain their focus on covered bonds and away from RMBS. In the commercial mortgage market, even though covered bonds are much better off than CMBS, the most attractive instrument for an insurance company from a capital perspective is still the underlying commercial mortgage loan.

HOW WELL ARE COVERED BONDS OFF IN THE END, AND ARE INSURANCE COMPANIES ALREADY ACTING BASED ON SOLVENCY II RULES...?

The 2011 changes were positive for covered bonds in general and especially for the AA rated sector. After many investors had already turned their focus away from the AAA rating level, the insurance sector was the last group out there for which a downgrade below AAA had a significant economic meaning.

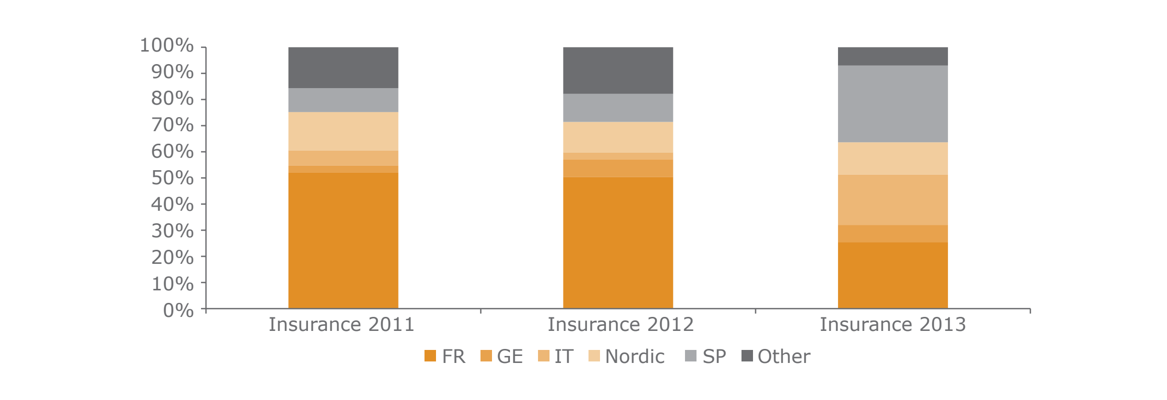
The difference between AAA and AA rated covered bonds will still be there but compared to the QIS 5 numbers it has become very small. As is the case Basel LCR proposals for the banking sector, the relevant rating level where treatment materially changes is AA-. Dropping below this level will mean that covered bonds are treated as senior unsecured exposure, with capital charges in the 5Y sector going up from 4.5% to 7%.

Large parts of the covered bond market have by now however migrated down to ratings below the AA- moving them away from preferential treatment. As such Solvency II is probably the one regulatory initiative most favouring sovereign debt over private sector assets.

Because of the uncertainties around the implementation timing we have not come across many insurance companies that would already act based on Solvency II rules. Most accounts are running their models in the background and simulate capital needs but the rules haven't arrived in the actual investment process yet.

Quite contrary to the incentives pro sovereign debt that Solvency II is setting, many insurance companies have in fact been moving in the opposite direction. Especially in the periphery, the insurance sector has been focussing away from sovereign debt and has increasingly looked at covered bonds. They are at these rating levels are very inefficient under Solvency II rules but many insurance accounts have focussed on their own recovery assumptions for covered bonds relative to sovereign debt and the fact that covered bonds have been significantly more stable spread wise in peripheral markets than the respective sovereign debt product.

> FIGURE 5: MONEY SPENT BY INSURANCE SECTOR ON EUR BENCHMARK PRIMARY MARKET COVERED BOND DEALS 2011-2013



2.2.3 MIFID AND ITS UNINTENDED CONSEQUENCES – AN UPDATE

By Richard Kemmish, Chairman of the ECBC Market Related Issues Working Group

In last year's fact book we commented on some of the unintended consequences of the proposed MIFID2 rules on the way in which we trade covered bonds. One year on and the level of certainty around the topic has marginally increased but so has its importance. With the increased focus on the liquidity of the covered bond product, not least for the Liquidity Coverage Ratio, and the declining volumes of actual trading that we have seen in the current highly technical market conditions, anything which can either help or hinder the trading of our product is of vital importance.

WHAT PROBLEMS DID WE IDENTIFY LAST YEAR?

MIFID2 (and MIFIR, the proposed new Regulation that will work in conjunction with the Directive) raised several concerns in the covered bond trading community. Some of these stem from the way in which we trade covered bonds currently, mainly by 'phone, frequently with smaller and more regionally focused investment banks providing substantial liquidity. Forcing trades into either multi-lateral trading venues – that covered bond traders used to use but which were found to be unable to cope with the volatility at the onset of the crisis - or through Systematic Internalisers (SIs) – a status which few of the market makers currently qualify for, is going to disrupt trading patterns with potential unintended negative impacts on covered bond markets.

Similarly the introduction of greater price transparency both before and after a bond has traded, although a laudable enough objective, could in fact reduce the liquidity available to investors as many members of the ECBC's Market Related Issues Working Group have argued.

Pre-trade price transparency can only really be achieved via a screen based system but is only useful if investors access the screen regularly.

Finally, no market maker will feel confident offering a good price in a 'market moving' sized block of bonds (a volume that is now far smaller than it used to be) if they know that the entire market will be aware of their position and the price they paid for it shortly afterwards. The ECBC's Market Issues Working Group has long argued that larger trades should be subject to some sort of delay in order to protect the commercial ability of the traders to unwind the large trades.

WHAT HAS CHANGED?

The problem of where covered bonds are traded may have been partially alleviated by a new form, the 'Organised Trading Facility'. According to Council for bonds (but not equities) an OTF operator, in order to facilitate client execution, can use 'matched principal trading' (MPT) to interpose between the buyer and seller in such a way that it is not exposed to market risk and provided that the client is informed. The OTF operator is however not allowed to execute client orders against its proprietary capital. The European Parliament's position is more restrictive as it does not allow MPT and, for bonds admitted to trading on a regulated market or traded on an MTF, OTF trading would be limited to large in scale orders. Both Council and European Parliament allow the application of discretion as to how trades are executed.

Also the definition of Systematic Internalisers is evolving in the Council text with the inclusion of quantitative criteria to capture more bilateral trading. The Council definition refers to 'any investment firm which, on an organised, frequent, systematic and 'substantial' (new quantitative criterion) basis, deals on [its] own account by executing client orders outside a regulated market or an MTF or an OTF'. Also this can be product-by-product, a market maker might be an SI for the purposes of covered bonds but not for equities, for example. Of course this all begs many definitional questions but is a step towards restricting OTC trading .

On the point of pre-trade price transparency there seems to be a growing awareness at both Council and Parliamentary level that the current proposal may have detrimental impacts on liquidity and that therefore the requirements should be properly calibrated and indicative pricing should be allowed in a voice trading market.

Council consider that the pre-trade transparency requirements should be different for different types of trading systems (quote-driven, order-book, voice broking, etc) and have asked ESMA (who will be responsible for the technical implementation standards) to create a definition of voice trading (sounds obvious enough) and a relevant trade size for which pre-trade disclosure can be waived. The European Parliament text similarly provides that pre-trade disclosure obligations may be suspended for bonds that meet the ESMA standards.

Also both Council and European Parliament support an exemption from the pre-trade transparency rules for "orders that are large in scale compared with normal market size", to quote the Council text.

Post-trade price transparency is expected to be amenable to some form of compromise between the Council and European Parliament – more of a delay for more significant trades and possibly disclosure of prices without concurrent disclosure of volumes. Both Council and European Parliament seem to contemplate some level of flexibility, in particular allowing that large trades should be subject to more of a delay. European Parliament have said that 'deferred publication' of prices should be allowed based on the type and size of the transaction and the 'liquidity profile' of the instrument. Council's text is broadly similar but also includes the idea of allowing publication of aggregated transactions during extended periods.

But the devil is in the detail, ESMA's technical standards will be key here and the ECBC's Market Issues Working Group will look to work closely with them over the coming months to ensure that these standards achieve the desired policy objectives of the legislation without any undue negative consequences.

WHEN IS THIS GOING TO BE IMPLEMENTED?

The most difficult question of all. In theory MIFID 2/MIFIR implementation should be Q1 2015 with some of the provisions being delayed to mid-2016 (up to 32 months after the primary legislation's entry into force expected in H1 2014). In particular the transparency requirements would need to wait for the ESMA technical standards to be agreed upon.

That is the theory. In order to meet that target the text has to be agreed by early 2014 as European Parliament's proceedings will grind to a halt ahead of its elections in May next year.

Given that the Council position was only recently agreed in June that leaves a relatively short window in which to agree on some fairly fundamental areas of disagreement between Council and European Parliament texts in the trilogue process along with the European Commission which is committed during this process to work towards strengthening transparency rules for both equity markets and non-equity markets (bonds and derivatives). There are many other topics to discuss, not just those highlighted above that are of direct relevance to the covered bond market and where there is a reasonable amount of common ground. And MIFID is just one of the many workstreams competing for the attention of the legislators.

Will the deadline be met? Will this be a good or a bad thing for the trading of covered bonds? Perhaps we will know more this time next year.

2.3 THE REPO TREATMENT OF COVERED BONDS BY CENTRAL BANKS

By Frank Will and Jan King, RBS

CENTRAL BANK REPOS: THE SAFETY NET FOR THE BANKING SYSTEM

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

The role of covered bonds in monetary operations varies by jurisdiction, not least since the nature of those operations is quite heterogeneous across jurisdictions. Broadly speaking, covered bonds receive more favourable treatment amongst those countries in which they play a more pivotal role in the funding of the domestic banking sector. This applies primarily in terms of eligibility of covered bonds as collateral for repo operations, but also in terms of the haircuts applied. At many of the major central banks (at least some types of) covered bonds are eligible as collateral in the discount window for emergency lending.

> FIGURE 1: COMPARING THE ELIGIBILITY OF COVERED BONDS FOR MONETARY POLICY OPERATIONS

Central Bank	Operation	Covered Bonds eligible?	Eligible Covered Bonds	Currency	Minimum Rating	Rating Treatment	Minimum Size	Own-name Covered bonds?
ECB	Repo Operations (Main and Long term Refinancing Operations)	Yes	Covered bonds compliant with UCITS Article 52(4) or similar safeguards	EUR, USD, GBP, JPY[1]	Down to BBB-	Best Rating	EUR 1 bn for Jumbo Covered Bonds, otherwise none	Yes[2]
Fed	SOMA Operations	No	None	USD	n/a	n/a	n/a	n/a
	Discount Window	Yes	US Covered Bonds	AUD, CAD, CHF, DNK, EUR, GBP, JPY, SEK	BBB	Lowest Rating	n/a	No
			German Pfandbriefe		AAA			
BoE	Operating Standing Facilities, Short term OMOs	No	n/a	GBP, EUR, USD, AUD, CAN, CHF, SEK	n/a	n/a	n/a	n/a
	Longer Term Repo Operations	Yes	UK, French, German & Spanish regulated covered bonds		AAA	Must be provided by two or more of S&P, Moody's & Fitch	GBP 1 bn or EUR 1 bn (depending on issuance currency)	No
	Discount Window	Yes	UK, US & EEA Covered Bonds		A-/A3, if AAA at issue		None	Yes

1 Since 9 November 2012, certain foreign currency-denominated debt instruments are again accepted as eligible collateral for Eurosystem credit operations, subject to the fulfilment of the relevant eligibility criteria. During the period from October 2008 and December 2010, assets denominated USD, GBP or JPY were already repo eligible. Non-EUR-denominated securities are subject to additional haircuts (16% for USD and GBP, 26% for JPY).

2 On 18 July 2013 the ECB decided to apply additional markdowns for retained covered bonds. The additional haircuts will be 8% for covered bonds rated AAA to A- (Credit Quality Steps 1&2) and 12% for covered bonds in the BBB category (Credit Quality Step 3).

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

Source: RBS, Central Banks.

1. EURO AREA: ELIGIBILITY CRITERIA FOR COLLATERAL IN EUROSYSTEM OPERATIONS

The ECB has been a key source of liquidity for banks in the Eurosystem during the credit crunch and the ongoing European debt crisis through its repo operations. The role of covered bonds within the ECB's liquidity operations has become an increasingly important one. While during certain periods over the last five years the benchmark covered bond market was shut for many issuers out of Europe's periphery the ECB continued to provide liquidity to those banks. Measures of this type include the two 3-year long-term refinancing operations the ECB conducted in December 2011 and in February 2012 in the framework of which banks took more than EUR 1 trn in gross liquidity – backed by eligible collateral. Many covered bond programmes have been set up not just as an additional funding channel, but also in order to allow the banks to use the repo facilities at the ECB as means to access liquidity in a closed wholesale market. In July 2013, the ECB decided to apply additional haircuts for retained covered bonds.

After spurring the covered bond market into action in 2009 with its €60bn purchase programme, covered bonds have gone on to be one of fastest growing assets in terms of collateral posted to the ECB, increasing by c.188% in amounts posted since 2007 (second in terms of growth only to ABS and non-marketable assets) and exceeding the increase in total collateral posted for repo operations (116%).

ECB Repo Operations:

Article 18.1 of the Statute of the European System of Central Banks and of the European Central Bank states that the ECB and the national central banks may conduct credit operations with credit institutions and other market participants, as long as lending is "based on adequate collateral"[3]. According to the ECB, adequacy means firstly, that collateral must protect against losses in credit operations, and secondly, that there must be sufficient collateral potentially available to ensure that the Eurosystem can carry out its tasks.

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

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

Criteria	Standard Collateral Rules
Type of Asset	> Debt instrument having a coupon that cannot result in a negative cash flow > Coupon should be zero coupon, fixed-rate coupon, multi-step coupon or floating-rate coupon linked to an interest rate reference or yield of one euro area government bond with a maturity of one year or less or to rating of issuer or inflation-indexed > Debt instruments, including covered bonds, but not including ABS, must have a fixed, unconditional principal amount > Limits on the use of unsecured bank bonds: The value assigned to unsecured bonds issued by a credit institution or an entity with close links to a credit institution must be less than a share of 5% in the value of the collateral pool of a counterparty (after haircuts), unless the market value of these assets is not higher than €50m

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

Criteria	Standard Collateral Rules
Definition of Covered Bonds	> The ECB does not provide an official definition of what they classify as covered bonds in the context of eligible collateral > In general, 'Covered Bank Bonds' for ECB collateral purposes means bonds issued in accordance with Article 52 (4) of the UCITS Directive, (i.e. subject to covered bond specific legislation) or similar safeguards > Covered bonds which do not meet these criteria (general law-based covered bonds) but meet all other requirements are eligible but classified as 'Credit Institution Debt Instruments' > Covered bonds with external, non-intra group MBS as well as both internal and external public sector ABS in the cover pool are no longer eligible as collateral for repo transactions since March 2013. However, the ECB granted a grandfathering period of two years until 28 November 2014 for already issued covered bonds
Cash Flow Backing ABS	> Must be legally acquired in accordance with the laws of a member state in a "true sale" > Must not consist of credit-linked notes (i.e. cannot be a synthetic structure), or contain tranches of other ABS > Collateral must be homogeneous: mixed pools (ie commercial and residential mortgages together) are not acceptable
Tranche and Rating	> Covered Bonds need to be rated at least BBB- on a 'best-rating' basis. > In case of a structured issue, the tranche (or sub-tranche) must not be subordinated to other tranches of the same issue. Since July 2013 in order to be eligible an ABS needs two "single A" ratings from the four major agencies. However, since June 2012 the minimum rating threshold for ABS has been temporarily lowered to BBB- (S&P) / Baa3 (Moody's) / BBB- (Fitch) / BBB (DBRS) on a second-best basis until further notice > In September 2012 the ECB suspended the minimum credit rating threshold in the case of instruments issued or guaranteed by the central government of countries that are eligible for OMT or are under an EU-IMF programme and comply with the attached conditionality
Place of Issue	> European Economic Area (EEA)
Settlement Procedures	> Transferable in book-entry form > Held and settled in the euro area
Acceptable Market	> Debt instrument must be admitted to trading on a regulated market or a non-regulated market as specified by the ECB
Type of Issuer/ Guarantor	> Central banks, public sector or private sector entities or international institutions
Place of Establishment of the Issuer/ Guarantor	> Issuer must be established in the EEA or in non-EEA G10 countries and guarantors must be established in the EEA
Currency of Denomination	> EUR, USD, GBP, JPY[4]

Source: RBS, ECB

On 18 July 2013 the ECB implemented its current haircut scheme, graduating haircuts according to differences in maturities, liquidity categories and the credit quality of the assets concerned (see the next two tables). The minimum credit threshold for marketable and non-marketable assets in the Eurosystem collateral framework remains at investment grade level.

4 Since 9 November 2012, certain foreign currency-denominated debt instruments are again accepted as eligible collateral for Eurosystem credit operations, subject to the fulfilment of the relevant eligibility criteria. During the period from October 2008 and December 2010, assets denominated USD, GBP or JPY were already repo eligible. Non-EUR-denominated securities are subject to additional haircuts (16% for USD and GBP, 26% for JPY).

In order to increase the collateral availability of ABS the minimum rating threshold was lowered from "triple A" to "single A" on a second-best basis as part of the July 2013 changes. However, the measure has no market impact since the June 2012 temporary scheme (which set the threshold to "triple B" until further notice) is still in place (as per July 2013).

On the other hand, the new framework implemented in July 2013 penalises retained covered bonds, to which additional markdowns are applied. The additional haircuts will be 8% for covered bonds rated AAA to A- (Credit Quality Steps 1&2) and 12% for covered bonds in the BBB category (Credit Quality Step 3).

Back in September 2012, the ECB decided that marketable debt instruments denominated in currencies other than EUR, namely USD, GBP and JPY, and issued and held in the euro area, are eligible as collateral until further notice. This measure reintroduces a similar decision applicable between October 2008 and December 2010, with appropriate valuation markdowns.

Covered bonds with external, non-intra group MBS as well as both internal and external public sector ABS in the cover pool are no longer eligible as 'covered bank bonds' collateral for repo transactions (since 31 March 2013). To our understanding, Covered bonds with external RMBS in their pool would still be repo-eligible but not be treated as 'covered bank bonds' and thus would face higher repo haircuts.

> ECB Haircuts by Liquidity Category and Residual Maturity

Credit Quality Steps 1 and 2 (AAA to A-)	**Liquidity Category I** Government Bonds		**Liquidity Category II** Local & Regional Govt, Supras & Agencies, Jumbo Covered Bonds		**Liquidity Category III** Traditional Covered Bonds, Structured CBs, Multi-Issuer CBs, Corporate Bonds		**Liquidity Category IV** Unsecured Bank Bonds		**Liquidity Category V** ABS
Residual maturity (years)	fixed	zero	fixed	zero	fixed	zero	fixed	zero	
0-1 & FRNs	0.5	0.5	1.0	1.0	1.0	1.0	6.5	6.5	10.0
1-3	1.0	2.0	1.5	2.5	2.0	3.0	8.5	9.0	
3-5	1.5	2.5	2.5	3.5	3.0	4.5	11.0	11.5	
5-7	2.0	3.0	3.5	4.5	4.5	6.0	12.5	13.5	
7-10	3.0	4.0	4.5	6.5	6.0	8.0	14.0	15.5	
>10	5.0	7.0	8.0	10.5	9.0	13.0	17.0	22.5	

Credit Quality Step 3 (BBB+ to BBB-)	**Category I**		**Category II**		**Category III**		**Category IV**		**Category V**
Residual maturity (years)	fixed	zero	fixed	zero	fixed	zero	fixed	zero	
0-1 & FRNs	6.0	6.0	7.0	7.0	8.0	8.0	13.0	13.0	22.0
1-3	7.0	8.0	10.0	14.5	15.0	16.5	24.5	26.5	
3-5	9.0	10.0	15.5	20.5	22.5	25.0	32.5	36.5	
5-7	10.0	11.5	16.0	22.0	26.0	30.0	36.0	40.0	
7-10	11.5	13.0	18.5	27.5	27.0	32.5	37.0	42.5	
>10	13.0	16.0	22.5	33.0	27.5	35.0	37.5	44.0	

Source: ECB, RBS (Assets that are given a theoretical value will be subject to an additional 5% haircut. Furthermore, an additional haircut is applied to retained covered bonds, 8% for retained covered bonds in the Step 1&2 category and 12% for Step 3 covered bonds.)

Classification of covered bonds within the Eurosystem operations

The ECB considers covered bonds to be a relatively liquid asset class. Hence, covered bonds benefit from preferential liquidity class classification and favourable haircut valuations for repo transactions with the ECB when compared with, for example, ABS (please see below, for further detail on the latest changes).

Moreover, unlike senior bank debt (and government-guaranteed senior bank debt from 2015), the ECB accepts self-issued (retained) "covered bank bonds" as collateral (see below for more information on the treatment of retained bonds). Thus, like certain forms of ABS, covered bonds allow issuers to make assets held on their balance sheets eligible for the ECB's liquidity operations.

The Eurosystem does currently not provide an official definition of what is classified as "covered bond". In general, the Eurosystem accepts both UCITS and non-UCITS compliant covered bonds as collateral as long as they otherwise fulfil the general eligibility criteria. Generally, debt instruments are classified as "covered bank bonds" if they are issued in accordance with the criteria set out in Article 52(4) of the UCITS Directive. Those bonds are grouped either into liquidity category II in case of Jumbo covered bonds, i.e. bonds with a minimum issue size of EUR 1 bn and at least three market makers, or into liquidity category III in case of traditional non-Jumbo covered bonds. Over the last few years the market has moved away from the "Jumbo" definition and we would not be surprised if the ECB were to also update its internal criteria at one stage.

"Structured" covered bonds are issued under a general legal framework, rather than being subject to "special public supervision", they do not fall within the UCITS definition and as such have not been recognised as covered bank debt by the ECB from a liquidity haircut perspective and in the past were assigned to category IV similar to senior unsecured bank debt. However since 1 January 2011 all non-Jumbo covered bonds, including "structured covered bonds" and multi-issuer covered bonds, together with traditional (UCITS-compliant) covered bonds, have been classified in liquidity category III. As of June 2013, also all Spanish covered bonds – including single name bonds – are classified as Category III securities. Interestingly, the ECB has classified Commerzbank's inaugural EUR 500 m SME covered bond issued in February 2013 as "structured covered bond" and has put it into Liquidity Category III next to other non-Jumbo covered bond.

For "structured covered bank bonds" there are additional requirements, including the following: (1) substitution asset limit of 10%, which can be exceeded at the discretion of the National Central Bank, (2) maximum LTV limit of 80% for residential and 60% for commercial mortgages, (3) minimum mandatory OC of 8% for residential and 10% for commercial mortgages, (4) maximum loan amount for residential real estate loans of EUR 1mln, (5) covered bond must have a long-term minimum rating of A-/A3.

Covered bonds with external, non-intra group MBS as well as both internal and external public sector ABS in the cover pool are no longer eligible as collateral for repo transactions (since 31 March 2013). However, the ECB granted a grandfathering period of two years until 28 November 2014 for already issued covered bonds. This means that while new issues with external RMBS or other ABS in the cover pool are no longer repo eligible since the end of March 2013, tap issues of grandfathered covered bonds will remain eligible during the grandfathering period, as long as no additional external RMBS or ABS are added to the cover pool. Generally, Covered bonds with external RMBS in their pool would still be repo-eligible but not be treated as 'covered bank bonds' and thus would face higher repo haircuts.

Covered bonds and "close link" exemption

"Covered bank bonds" also benefit from certain preferential treatments compared with other bank debt when it comes to self-issued bonds. The ECB states that "irrespective of the fact that a marketable or non-marketable asset fulfils all eligibility criteria, a counterparty may not submit as collateral any asset issued or guaranteed by itself or by any other entity with which it has close links"[5]. This means that banks cannot, for example, use their own senior unsecured debt directly as collateral with the ECB.

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

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

However, one of the main aims of the July 2013 ECB haircut scheme revision was to (further) curb the use of retained (own-name) covered bonds as collateral. In fact, while the changes in the haircut schedule were generally positive for market-placed covered bonds, they penalised the use of own-name covered bonds in ECB liquidity operations. Many retained covered bonds are still favourably treated when compared to ABS, but the relative advantage has been reduced considerably. Retained covered bonds are typically issued as floating rate notes. Therefore, they fall under the residual maturity category of up to 1 year. Depending on the rating and the Liquidity Category, the haircut of retained covered bonds is still between 1 - 3 percentage points lower than that for respective ABS. Only if banks are submitting own-name covered bonds with fixed coupons and remaining maturities of three years and more, the new haircut is higher than that for ABS. However, we believe that, taking into account the stricter eligibility criteria under the covered bond legislations, the reduced advantage of retained covered bonds will lead to some shifts from retained covered bonds towards ABS in the use of collateral.

Back in November 2012, the ECB already amended the close-link provisions regarding own-use of covered bonds as collateral. Since then, only CRD compliant covered bonds and UCITS compliant covered bonds that offer comparable protection have been eligible. In a similar move, the ECB decided to remove own-name government-guaranteed bank bonds (and retained covered bonds backed by these) from the list of eligible collateral by 1 March 2015.

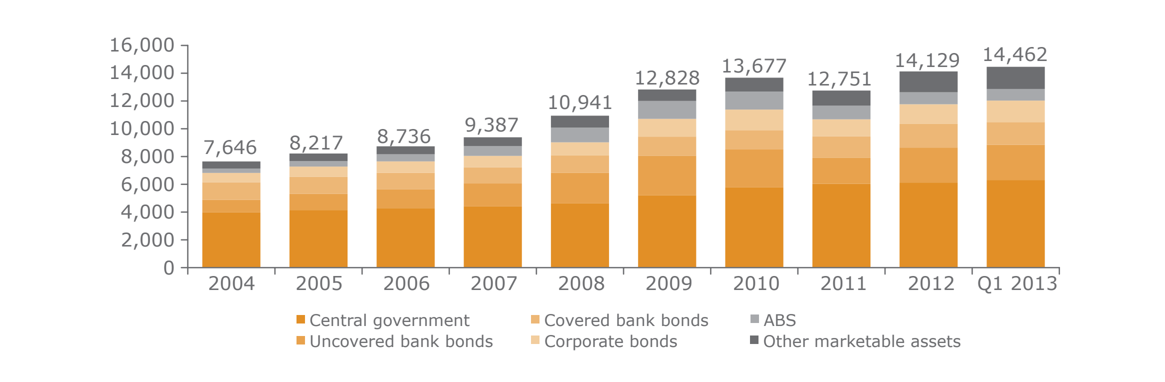
Use of Covered Bonds as Collateral in Eurosystem Operations

The overall volume of marketable assets which had become eligible for repo operations had increased over 80% from EUR 7.6 trn in 2004 to EUR 13.7 trn at year-end 2010. In 2011 the eligible collateral volume decreased for the first time – by circa EUR 1 trn - before marking a new all-time record level in Q1 2013 at EUR 14.6 trn, almost twice the levels recorded in 2004. At the end of Q1 2013 central government debt accounted for the largest share (44%) followed by uncovered bank bonds (18%), covered bank bonds (11%), corporate bonds (11%), ABS (6%) and other bonds, which include regional government securities (11%).[6]

5 "Close links" means the counterparty is linked to an issuer/debtor/guarantor of eligible assets by one of the following forms: (i) the counterparty owns directly, or indirectly, through one or more other undertakings, 20 % or more of the capital of the issuer/debtor/guarantor; or (ii) the issuer/debtor/guarantor owns directly, or indirectly through one or more other undertakings, 20 % or more of the capital of the counterparty; or (iii) a third party owns more than 20 % of the capital of the counterparty and more than 20 % of the capital of the issuer/debtor/guarantor, either directly or indirectly, through one or more undertakings [ECB, "The Implementation on Monetary Policy in the Euro Area", February 2011]

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

> Figure 2: Eligible collateral by asset type, EUR bn



Source: ECB, RBS

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

Over the last few years, there has been a general trend to lower the overall quality and/or liquidity of the collateral used by the banks for repo operations. The share of central government debt had fallen sharply, from a 31% share in 2004 to just 10% in 2008; though this has slightly risen again over the last few years to 15% as of Q1 2013.

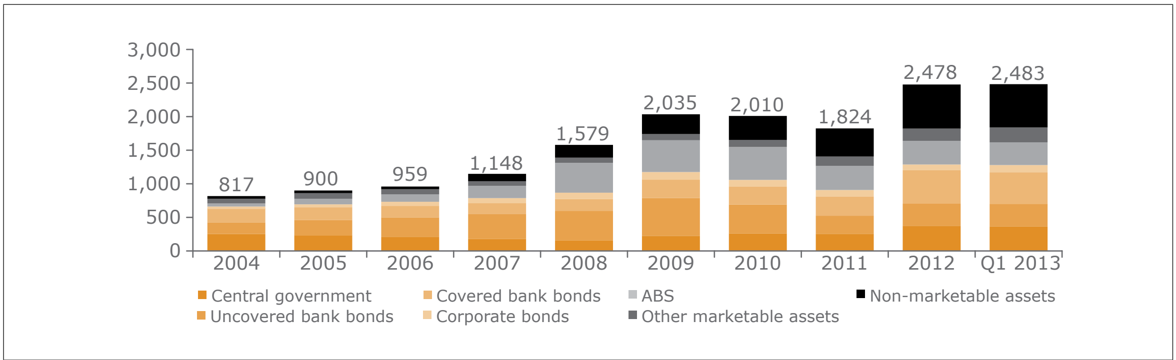
The use of covered bank bonds in the Eurosystem repo operations dropped from 26% in 2004 to 11% in 2008. Since then it has increased again and stood at 20% as of end 2012 (and 19% as of Q1 2013).

The share of uncovered bank bonds (which included general law based covered bonds) dropped from 21% in 2010 to 15% in 2011 after it had significantly increased from 21% in 2004 to 32% in 2007. It accounted for 15% of the total as of Q1 2013.

ABS grew from 6% in 2004 to 28% in 2008 before stabilising at 23% and 24% in 2009 and 2010 respectively. Their level decreased again to 14% as of end Q1 2013.

Figure 3 also shows the large rise in the main and long-term refinancing operations of the Eurosystem banks in autumn 2008 and then an even larger increase during the course of 2009. Total usage stabilised in 2010 and declined in 2011 before marking new heights in 2012 and Q1 2013 at EUR 2.5 trn.

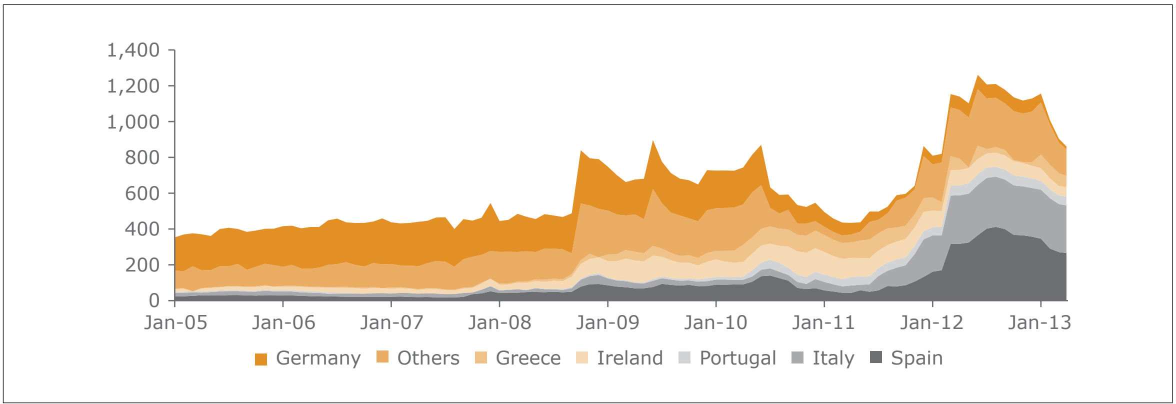
> Figure 3: Actual use of collateral by asset type, EUR bn



Source: ECB, RBS

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

> Figure 4: Composition of total Eurosystem lending to Euro Area credit institutions, EUR bn



Source: Eurosystem, RBS

Funding via the Eurosystem's refinancing facilities is awarded on an auction basis. Traditionally this auction has taken the form of a variable rate tender, whereby financial institutions bid for funds. Bids with the highest interest rate levels are satisfied first and subsequently bids with successively lower interest rates are accepted until the total liquidity to be allotted is exhausted. In 2008, the effective refinancing rate tended to be above the target refinancing rate, as the number of banks bidding for funding through the ECB's refinancing operations had spiked, pushing the effective rate higher due to the greater demand. To counteract this and to bring the effective rate in line with the target rate, the ECB decided to perform its refinancing operations on a fixed-rate tender basis from March 2009, originally until March 2010. This has meant that for many issuers, the cost of raising funds via the ECB has been significantly cheaper compared to issuing covered bonds in the capital markets.

In March 2010, the ECB announced that it would begin to return to regular variable rate tenders in the regular three-month operations, beginning with those in April 2010, as part of the gradual phasing out of the non-standard measures. However, as a result of the sovereign debt crisis, this measure was postponed on a number of occasions - firstly in May 2010 (alongside the initiation of the Security Markets' Programme), then subsequently in June, September and December 2010 as well as in March and June 2011. In August 2011, the ECB announced the extension of fixed rate, full allotment procedures for all the Q4 2011 operations, as well as a supplementary 6m LTRO. In late 2011 the ECB announced two 3-year LTROs that were conducted as fixed rate tender procedures with full allotment at the end of December 2011 and in February 2012. In May 2013 the ECB announced it would continue conducting its Main Refinancing Operations (MROs) as fixed rate tender with full allotment for as long as necessary, and at least until the end of the 6th maintenance period of 2014 on 8 July 2014. This procedure will also remain in use for the Eurosystem's special-term refinancing operations, which will continue to be conducted for as long as needed, and at least until the end of the second quarter of 2014. The fixed rate in these special-term refinancing operations will be the same as the MRO rate.

Conclusion on covered bond treatment

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

Firstly the ECB has focussed on the importance of covered bonds as a means for banks to access long term funding: "Issuing covered bonds enhances a bank's ability to match the duration of its liabilities to that of its mortgage loan portfolio, enabling a better management of its exposure to interest rate risk. Other secured funding products, such as repos, are unlikely to have the same asset-liability matching attributes offered by covered bonds. All these issues are all the more important today given the increasing role of short-term refinancing in banks' balance sheets. In certain instances, rolling over short-term funding might be less expensive or better in terms of reputation, but this could pose challenges to the management of assets and liabilities at some point. In addition to improving banks' structural asset-liability mismatch, covered bonds offer a wider geographical diversification, as issuers tap into a larger European market."[7] Moreover, a further key advantage comes from the absence of effective risk transfer and the desirable incentives this creates for the originating banks. As former ECB president Trichet noted: "importantly, covered bonds do not involve the transfer of the credit risk implied by underlying assets from the issuer to the investor. The credit risk stays with the originator, preserving the incentives for prudent credit risk evaluation and monitoring."[8].

Such positive attitude is reflected both in the ECB's current favourable treatment of covered bonds within its repo operations, - they are allocated in a very favourable liquidity category (Jumbo covered bonds rank alongside the debt of the EFSF, EIB and the explicitly German-guaranteed agency KfW) and in the ongoing changes the ECB implements to these operations, for example the re-classification of liquidity category and more favourable haircuts applied to 'structured covered bonds' and 'multi-issuer covered bonds' since the beginning of 2011. At the same time, the ECB has tightened the requirements back in November 2012 to ensure the quality of the covered bonds posted as collateral and in July 2013 to further curb the use of retained (own-name) covered bonds as collateral.

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

The Bank of England (BoE) operates a rather stricter regime than the ECB in terms of eligible collateral within the Sterling Monetary Framework. The BoE defines three collateral sets, which are eligible to varying degrees for its monetary operations: (1) the Narrow Open-Market-Operations (OMO) collateral set, (2) the Wider OMO collateral set and (3) Discount Window Facility (DWF) Collateral.

Within the Sterling monetary framework operations, covered bonds are only included within the latter two wider collateral sets, namely the 'Wider OMO Collateral Set' and 'DWF Collateral'. The eligibility criteria for covered bond inclusion can be found below:

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

8 Keynote address by Jean-Claude Trichet, Munich, 13 July 2009

>FIGURE 5: BANK OF ENGLAND'S COVERED BOND ELIGIBILITY CRITERIA

	Wider OMO Collateral Set	DWF Collateral Set
Eligible currencies	GBP, EUR, USD, AUD, CAN, CHF, and SEK	
Geography	UK, French, German and Spanish regulated Covered Bonds	EEA
Minimum Rating by two or more of S&P, Moody's and Fitch	AAA rated	A3/A- provided that AAA rated at time of issuance
Minimum Size	At least £1bn or €1bn	n/a
Own Name Covered Bonds	No	Yes
Underlying assets	UK or EEA residential mortgages, social housing loans or public sector debt	UK, EEA residential mortgages, UK, US or EEA social housing loans or public sector debt, commercial mortgages, SME loans and certain ECA-guaranteed loans

Source: Bank of England, RBS

For the Wider OMO collateral set, only a subset of the covered bond universe is eligible. The criteria are based on a combination of both credit quality (hence underlined by the AAA rating requirement) and liquidity. For example covered bonds from Nordic issuers, one of the core covered bond markets with an acknowledged safe haven status, are not included in the Wider OMO Collateral Set, whereas Spanish covered bonds are generally included but do currently not fulfil the minimum rating requirement anymore. Meanwhile under the current guidelines, even for some of the UK banks, mainly their Euro covered bonds would be eligible, given that most of the Sterling covered bonds still fall below the minimum issue size threshold of GBP 1 bn.

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

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

As mentioned above, the Bank of England conducts a number of different monetary policy operations. The table below shows the eligibility of different collateral sets for the various operations.

Monetary Operation	Narrow OMO Collateral Set	Wider OMO Collateral Set	DWF Collateral
Real Time Gross Settlement	Yes	No	No
Operational Standing Facilities	Yes	No	No
Short-term OMOs	Yes	No	No
Indexed Long-term Repo Operations	Yes	**Yes**	No
Discount-Window Facility	Yes	**Yes**	**Yes**
Extended Collateral Term Repo	Yes	**Yes**	**Yes**
Funding For Lending Scheme	Yes	**Yes**	**Yes**

Source: Bank of England, RBS

Operational Standing Facilities

The Operational Standing Lending Facility provides a ceiling for the overnight interest rates through its overnight lending facility (against the narrow OMO collateral set), which is usually set at 25bp above the Bank of England rate. The Operational Standing Deposit Facility is an unsecured overnight deposit with the central bank which is currently set 50 bps below the Bank of England rate. This is designed to limit volatility in overnight interest rates by providing an arbitrage mechanism to prevent money market rates moving far from the bank rate and allowing participating banks to manage unexpected frictional payment shocks.

Short-term Open Market Operations (OMOs)

Short-term Open Market Operations (OMOs) are designed to supply the quantity of reserves consistent with the aggregate target set by the banks for that maintenance period (the period over which compliance with reserve requirements is calculated) under the reserve averaging process. These operations have been suspended since March 2009 as a result of the BoE's asset purchase scheme (QE), so the supply of reserves is currently determined by the level of reserves. At the moment the BoE is operating a "floor system" where all reserves are remunerated at the Bank Rate.

Long-term Repo Operations

Long term indexed repo operations are provided by the Bank of England "to provide indexed liquidity insurance without distorting banks' incentives for prudent liquidity management and minimising the risk being taken onto the BoE's balance sheet." These operations are indexed to the bank rate, allowing counterparties to use the facility without having to take a view on the future path of the Bank rate (and also reducing the BoE's exposure to market risk). In these operations banks can borrow against narrow, as well as wider OMO collateral, which includes covered bonds meeting the aforementioned criteria.

The BoE typically offers funds in long-term repo operations once every month; offering a preannounced quantity at a single maturity. Normally, two operations with a three-month maturity and one operation with a six-month maturity are offered; though the BoE can alter these in cases of wider stress.

The BoE has a **unique auction pricing mechanism** and does not provide a simple schedule of long-term operations, as is the case for the ECB. Instead it operates a unique auction design. Firstly the size of the long-term indexed repo is fixed in advance. Subsequently, participants submit bids for a nominal amount of liquidity and a spread in basis points to the bank rate. Banks can submit separate bids against narrow OMO collateral or against the wider OMO collateral (where covered bonds are eligible). Multiple bids can be placed against either of the collateral sets[9]. Alternatively (or in addition) 'paired' bids can be submitted consisting of a single nominal amount and two spreads the counterparty is willing to borrow at, one for each collateral set. If both bids are above the clearing spread for the auction, the participants will be allocated against the bid which offers them better value which is defined as the highest spread relative to the clearing spread of the two collateral types. For example a paired bid for GBP 2 m of liquidity, at Bank Rate +15 bps for the narrow collateral set and Bank rate +35 bps for the wider collateral set, where the auctions clear at Bank Rate +10 bps and Bank Rate +34 bps, then the participant would be allocated against the narrow collateral set (which is 5 bps above the clearing rate, whilst the wider one is only 1bp over). This is a trade off against the risk of overallotment if the participant instead submits two separate bids.

The auction then prices using a "uniform price" format, meaning all successful bidders (those bidding for liquidity at a higher price than the clearing spread) ultimately pay only the clearing spread.[10] There is one clearing

9 There is no maximum number of bids, only a maximum total value of bids from a single participant.

10 The rationale here is to avoid participants basing their bids on assumptions about others' behaviour.

spread for the narrow collateral and one for the wider collateral set. Thus, when pledging covered bonds in the BoE's long-term indexed repo operations, the ultimate cost to a bank will depend on the spread set for the wider collateral set in the auction. Crucially the proportion of the total fixed amount on offer which is allocated to each collateral set "is based on the pattern of bids received and the Bank's preferences for supply funds against each collateral set." This determines the amount of liquidity, against which covered bonds can potentially be pledged. So in this system the amount of liquidity on offer against the wider collateral set depends not only on demand for long-term repos on these assets but also on those in the narrower collateral set.

The Discount Window

The discount window is a bilateral facility used for emergency lending to an institution; providing liquidity insurance. It allows participants to borrow Gilts (or in extreme cases even cash) against a wider range of potentially less liquid eligible collateral. It acts as a "liquidity upgrade of collateral", hence the wider range of eligible collateral. Fees are paid when the Gilts are returned to the BoE in return for the original assets.

Collateral, which can be pledged, encompasses both the narrow and wider OMO collateral sets (described as level A and level B assets below) but also additional assets types. These can be subdivided further into high quality but illiquid collateral (level C) and level D (own-name covered bonds and securitisations). The fees charged for the discount window depend upon the type of collateral used and the proportion of eligible liabilities, which the lending would represent.

Hence covered bonds could potentially fall into three different categories. Firstly covered bonds which already qualify for the wider collateral set (see above) are considered level B assets. Then for covered bonds qualifying as DWF collateral but not the wider OMO collateral, these classify as level C assets, unless they are own-name covered bonds, in which case they classify as level D assets.

The Extended Collateral Term Repo (ECTR)

The ECTR was launched in December 2011 and activated in June 2012. It is a contingency liquidity facility that the BoE can activate in response to actual or prospective exceptional market-wide stress to undertake operations against a wider set of collateral than with its indexed long-term repo operations. All DWF Collateral is eligible for the ECTR facility – including own-name covered bonds. The BoE held an ECTR auction at least once a month until December 2012"[11]. Since then, the ECTR Facility remained activated but the Bank reviews demand for auctions on a monthly basis in consultation with ECTR eligible institutions. The Bank holds an auction only if there is sufficient demand[12].

The Funding for Lending Scheme

The FLS was launched on 13 July 2012 and is intended to encourage banks and building societies to increase their lending to UK households and corporates. Participants can borrow UK Treasury Bills against all DWF collateral. Both the fee and the amount participants can borrow will depend on their lending growth. The drawdown period started on 1 August 2012 and was extended up to the end of January 2015. As part of this extension (on 24 April 2013) the FLS was also expanded to count lending by certain non-bank providers of credit to the UK real economy.

The fees payable in the DWF operations depend on the category of collateral. For lending provided in return for Gilts[13] the fees (in basis points) for the different categories of collateral are set out below:

11 According to its Market Notice published on 15 June 2012

12 According to its Market Notice published on 20 November 2012

13 In the event that cash is lent instead, then the fee is the indexed bank rate in addition to the fees shown in the table; though such fees can vary at the bank's discretion.

Collateral Set				
% of Eligible Liabilities	A (Narrow collateral)	B (Wider collateral)	C	D
0%-10%	50	75	125	200
10%-20%	75	125	200	300
20%-30%	100	175	275	400
30%+	At discretion of the bank			

Source: Bank of England, RBS

The DWF is intended for borrowings of up to 30 days. A further 25 bps will be added for drawings with an initial maturity of more than 30 days (though the current theoretical maximum is 364 days). The table below summarises the above mentioned monetary operations:

	Operational Standing Facilities	Indexed Long-term Repo	Discount Window Facility (DWF)	Extended Collateral Term Repo Facility
What is the primary purpose of the operation?	Monetary policy implementation Bilateral liquidity insurance to deal with frictional payment shocks	Liquidity insurance	Bilateral liquidity insurance	Liquidity insurance
What is being borrowed?	Deposit facility: n/a Lending facility: sterling cash	Sterling cash	Gilts	Sterling cash
Eligible Collateral	Deposit facility: n/a Lending facility: Narrow	Narrow, Wider	DWF	Narrow, Wider, DWF
Fee	Deposit facility: 0% Lending facility: 0.75%	Auction determined uniform spread indexed to Bank Rate	Fee dependant on size of drawing and collateral delivered	Auction determined uniform spread indexed to Bank Rate
Maturity	Overnight	Typically 3 or 6 months	30 or 364 days	6 months
Frequency	Available daily, all day	Typically monthly	Available daily, all day	Monthly

Source: Bank of England, RBS (as of May 2013)

Additional disclosure requirements for residential mortgage covered bonds

The Bank of England requires additional disclosure and transparency for RMBS and covered bonds backed by residential mortgages. The BoE requirements include anonymised loan level information for securities from these two asset classes. This must be provided for investors, potential investors and "certain other market professionals acting on their behalf." The information must be provided on at least a quarterly basis and within one month of an interest payment date.

Since December 2012, any covered bonds backed by mortgages which do not fulfil the criteria became ineligible for use in any of the Bank of England's monetary policy operations[14].

Loan-level reporting also includes "the requirement for credit bureau score data" to be made available. This needs to be provided within a three-month period of the transaction's origination and must be updated on a quarterly basis. This is provided to enhance comparability between providers. The banks must provide the

14 With the exception of covered bonds already pledged within the Special Liquidity Scheme.

information on a 'comply or explain' basis. Where issuers are not able to provide certain data fields, this will not render a transaction ineligible automatically; instead the BoE will look at the rationale before determining eligibility and may choose to add additional haircuts. Nonetheless the BoE expects that ultimately all the mandatory information will need to be provided.

These additional transparency requirements do not apply to public sector covered bonds.

3. THE US: ELIGIBILITY CRITERIA FOR FEDERAL RESERVE OPERATIONS

The monetary policy operations of the Federal Reserve System work rather differently to those at the ECB or the Bank of England. The Federal Reserve Bank of New York implements monetary policy on behalf of the Federal Reserve System, as mandated by the Federal Open Market Committee (FOMC). Monetary policy is implemented through sales and purchases on the System Open Market Account (SOMA) at the Federal Reserve Bank of New York. This account is used both to maintain the overnight target rate for the federal funds rate (i.e. the US policy rate), as well as to undertake large scale asset purchase programmes decided upon by the FOMC. In particular, the three rounds of asset purchases (quantitative easing), the first consisting of Treasury securities, GSE debt and GSE-guaranteed MBS, the second solely of Treasuries and the third of agency MBSs, as well as the reinvestment of the coupons and principal payments received from the first round of QE, have all gone through this account. Currently covered bonds are not eligible for any of SOMA operations, which are restricted to US Treasury Bills, Notes and Bonds (including TIPS), Federal Agency securities[15] and MBS guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae; all of which must be denominated in USD. None of the additional operations put in place during the first stage of the financial crisis are currently still in place, meaning the only significant other monetary operation is the discount window.

Covered bonds and the Discount Window

Only a very small list of covered bonds is eligible for the discount window, namely: **US covered bonds** and **AAA-rated German Jumbo Pfandbriefe**. In the case of the German Pfandbriefe, for the AAA requirement the lowest rating of S&P, Moody's and Fitch is relevant. A much softer rating restriction of simply being investment grade is applied to US covered bonds.

"In general, the Federal Reserve seeks to value all pledged collateral at an internal fair market value estimate. Margins are applied to the Federal Reserve's internal fair market value estimates and are based on risk characteristics of the pledged asset as well as the anticipated volatility of the internal fair market value estimate of the pledged asset over an estimated liquidation period. Securities are typically valued using prices supplied by external vendors. Eligible securities for which a vendor price cannot readily be obtained will be assigned an internally modelled price."

The haircuts applied to the various assets eligible for use in the discount window are outlined below. Notably the foreign currencies eligible for the discount window are AUD, CAD, CHF, DKK, EUR, GBP, JPY and SEK.

The haircuts applied to covered bonds in the discount window operations are not very high and only marginally higher than those for Treasuries. For example for tenors of 5-10 years, USD-denominated Pfandbriefe are subject to a haircut of only 4%, the same as stripped Treasury notes or supranational paper, whilst US Covered bonds are only 1% higher. Nonetheless this reflects a positive stance of the Fed to all secured debt, since CMOs and AAA-rated ABS also receive this haircut.

Nonetheless the eligibility criteria for foreign issued covered bonds are very strict, including solely German Pfandbriefe. All other covered bonds effectively appear to be treated in the same manner as unsecured bank debt, i.e. being excluded from the discount window. Even other well-developed legislation based covered bond types, such as Obligations Foncières or any of the various Nordic covered bonds have not been included.

15 Fannie Mae, Freddie Mac and Federal Home Loan Bank.

		% of Market Value (by Maturity)		
Asset Class	**Asset Type**	**0-5 yrs**	**>5-10 yrs**	**>10 yrs**
US Treasuries	Bills/Notes/Bonds/TIPs	1.0	3.0	4.0
	STRIPs/Zero Coupon	2.0	4.0	8.0
FDIC Guaranteed	USD Denominated Bills/Notes/ Bonds	2.0	4.0	5.0
	USD Denominated Zero Coupon	3.0	5.0	9.0
	Foreign Denominated Bills/Notes/ Bonds	8.0	10.0	11.0
GSEs	Bills/Notes/Bonds	2.0	4.0	5.0
	Zero Coupon	3.0	5.0	9.0
Foreign Government Agencies	USD Denominated	2.0	4.0	7.0
	Foreign Denominated- AAA rated	8.0	10.0	13.0
Foreign Government, Foreign Government Guaranteed and Brady Bonds	USD Denominated- AAA rated	2.0	4.0	5.0
	USD Denominated- AA-BBB rated	3.0	5.0	6.0
	Foreign Denominated	8.0	10.0	11.0
Supranationals	USD Denominated	2.0	4.0	5.0
	Foreign Denominated- AAA rated	8.0	10.0	11.0
	Zero Coupon	3.0	5.0	9.0
Corporate Bonds	USD Denominated- AAA rated	3.0	5.0	6.0
	USD Denominated AA-BBB rated	5.0	7.0	8.0
	Foreign Denominated- AAA rated	9.0	11.0	12.0
US Issued Covered Bonds	**AAA rated**	**3.0**	**5.0**	**6.0**
	AA-BBB rated	**5.0**	**7.0**	**8.0**
German Jumbo Pfandbriefe	**AAA rated-USD Denominated**	**2.0**	**4.0**	**5.0**
	AAA rated- Foreign Denominated	**8.0**	**10.0**	**11.0**
Asset Backed Securities	AAA rated	2.0	5.0	17.0
	AA-BBB rated	11.0	14.0	18.0
	CDOs- AAA rated	8.0	9.0	10.0
	CMBS- AAA rated	3.0	7.0	8.0
Agency Backed Mortgages	Pass throughs	2.0	4.0	5.0
	CMOs	2.0	4.0	10.0
	Private-label CMOs- AAA rated	10.0	16.0	17.0
	Trust Preferred Securities	7.0	8.0	9.0
	Trust Deposit Facility- Term Deposits	0	n/a	n/a
	CDs, Bankers' Acceptances, CP, ABCP	3.0	n/a	n/a

Source: Fed, RBS

There is also a separate schedule for the percentage margin applied to loans, a number of categories of which are also eligible for the discount window facility. A further stipulation from the Fed is that obligations of the pledging depository institution (or of an affiliate) are not eligible collateral. In our understanding, this rules out own-name covered bonds.

4. SWITZERLAND: ELIGIBILITY CRITERIA FOR SWISS NATIONAL BANK (SNB) OPERATIONS

SNB monetary policy operations

Under its monetary policy framework, the Swiss National Bank (SNB) sets a 100 bps target range for the 3-month Swiss Franc LIBOR rate, with the SNB targeting the middle of this range. Repos are its preferred open market operation used to achieve this target. These are conducted in parts by auctions, which are typically held every day in form of volume tender (though a rate tender is also possible). The SNB can also conduct bilateral repo operations to affect money market operations during the course of the day. All these repo transactions must be 100% collateralised. The terms are set on a daily basis and the maturity of the operations may vary from one day to twelve months. Hence, the SNB does not have distinct long-term repo operations in the same manner as the ECB or the BoE. Furthermore, the SNB can issue its own debt certificates (SNB Bills) as a means of absorbing liquidity through its money market operations when targeting the aforementioned policy rate (or range). Such debt certificates can also be posted back to the SNB in the context of its repo operations (but cannot be used by banks to satisfy their minimum reserve requirements).

Under the SNB's typical volume tender, each counterparty offers for the amount of liquidity it is willing to provide for a given repo rate. If the total volume of offers exceeds the SNB's predetermined allotment volume, the SNB reduces the amounts offered proportionally. Each one of the counterparties receives the interest rate they bid. SNB Bill auctions are, as a rule, conducted in the form of a variable rate tender. Counterparties submit their offers comprising the amount of liquidity they are willing to provide and price at which they would do so. Counterparties can submit multiple bids, including at different interest rates. The SNB obtains liquidity from the participants that have made offers at or below the highest interest rate accepted by the SNB, paying the participants the interest rate stated in their offers.

In addition the SNB provides standing facilities (a liquidity shortage facility and an intraday facility). For such facilities the SNB does not actively intervene in the market but rather "merely specifies the conditions at which counterparties can obtain liquidity[16]." Repo transactions within the context of standing facilities must cover at least 110% of the funds obtained. The remaining monetary policy operations used by the SNB are an intraday facility for banks, foreign exchange swaps with various central banks, as well as foreign exchange purchases (a means of intervening into foreign exchange markets affecting CHF). The SNB can also create, purchase or sell derivatives on receivables, securities, precious metals and currency pairs.

Covered bonds and other collateral eligible for SNB repo operations

For the aforementioned monetary policy operations the SNB has a standard collateral set which does not distinguish between collateral eligible for different operations. This is in line with the ECB but in contrast to the BoE policy. The SNB accepts a slightly wider set of collateral for its operations. In this sense, the SNB operates much more like the ECB than the Fed or BoE, with the latter restricting eligible assets of short-term monetary policy operations to only the highest-quality liquid government securities, with the exclusion of covered bonds.

Only collateral included in the list of eligible collateral for SNB repos may be pledged in the repo transactions. In order to be eligible, the collateral assets must fulfil the following criteria:

> be issued by central banks, public sector entities, international or supranational institutions and private sector entities (securities issued by domestic banks and their subsidiaries abroad are not generally eligible as SNB collateral).

> the issuer is domiciled in the European Economic Area (EEA)

> have a fixed principal amount with an unconditional redemption

16 Guidelines of Swiss National Bank (SNB) on Monetary Policy Instruments.

> have a fixed rate, floating rate or zero coupon

> have a minimum volume of CHF100mln for securities denominated in Swiss Francs or CHF 1 bn for securities denominated in foreign currencies

> are traded on a recognised exchange or a representative market in Switzerland or member of the EEA with price data published on a regular basis.

> fulfil the rating requirements (at least one of the three rating agencies S&P, Moody's and Fitch rates the country and issue above the minimum threshold).

As such, covered bonds are eligible as long as they are not issued by a domestic Swiss bank. The criteria for the various classes of eligible assets are further split between foreign and Swiss franc denominated criteria, the latter being somewhat less stringent. Please find these below:

	Currency of Issue	Min. Rating of Creditor's Country of Domicile	Min. Rating of Security	Minimum issue size	Additional Criteria
Swiss Franc Securities	CHF	A/A2*	A/A2**	100 CHF m	Securities of foreign issuers must be listed on SIX Swiss Exchange
Foreign Currency Securities	EUR, USD, GBP, DKK, SEK, NOK	AA-/Aa3* (and must have registered office in Switzerland or an EEA country)	AA-/Aa3**	> CHF 1 bn equivalent (at time of issuance)	

* Securities of supranational organisations may be eligible irrespective of rating of country of domicile.

** Swiss public authorities, domestic mortgage bond institutions (Pfandbriefanstalten), the central issuing office of Swiss municipalities and Swiss issuers with explicit guarantee from Swiss Confederation are excluded from this requirement.

Source: SNB, RBS

All securities contained in the list of collateral eligible for SNB repo transactions form part of the SNB GC Basket. Based on their characteristics, the securities in this collective basket are assigned to three different baskets. The CHF GC Basket contains the securities denominated in Swiss francs. Securities in foreign currencies issued by sovereign countries and central banks make up the Government GC Basket (GOV GC Basket). The International GC Basket (INTL GC Basket) contains all other foreign currency securities. Securities in Swiss francs with a minimum volume of CHF 1 bn and a minimum rating of AA-/Aa3 are eligible for two baskets: the CHF GC Basket and either the GOV GC Basket or the INTL GC Basket. As is the case with all central banks the SNB can decide on a case-by-case basis which securities are eligible for its repo operations. Its rules explicitly state that it "may reject the inclusion of securities or withdraw securities that were previously included in the list, without providing any justification."

Own-name covered bonds

The SNB publicly states that it does not accept counterparties' own securities or "those issued by persons or companies that form an economic unit with the counterparty". It defines an enterprise as belonging to the same economic unit as the counterparty if 20% of the capital or voting rights are held. Nonetheless it explicitly states that "this 20% rule does not apply to participations in mortgage bond banks or similar institutions". Although it is not explicitly stated in official documents, SNB officials confirmed to us that own name covered bonds cannot be included within the boundaries set by the definition of eligible collateral.

5. NORWAY: ELIGIBILITY CRITERIA FOR NORGES BANK OPERATIONS

Norges Bank monetary policy operations

The policy rate of Norges Bank is the sight deposit rate, the rate of interest banks receive on their overnight deposits (up to a quota) in Norges Bank. As from 3 October 2011, a set volume of bank reserves in Norges Bank (a quota) started bearing interest at the key rate. Deposits in excess of this quota bear interest at a lower rate, the reserve rate (new liquidity management system). Unlike other central banks the key policy rate is not a target for overnight interest rates realised in money markets. Instead, the sight deposit rate form a floor for very-short term money rates, whilst the overnight lending rate charged to banks for overnight loans (for "D-Loans", see below) is the other though less important interest rate, which forms a ceiling for very short term money rates. This is typically set 100bp above the key policy rate. Norges Bank uses F-deposits (fixed-rate deposits) to remove unwanted liquidity out of the system.

In terms of providing liquidity, Norges Bank provides intraday and overnight loans ("D-Loans"), which must be 100% collateralised. The bank also provides longer term liquidity through "F-loans" (fixed-rate loans), repurchase agreements and currency swaps. F-loans are ordinary fixed-rate loans with a given maturity provided against acceptable collateral "in the form of approved securities." The interest payable on such loans is determined by a multi-price ('American') auction. Just like in the case of the SNB, Norges Bank determines the total amount to be allotted in such an operation. Bids for the loans are ranked in decreasing order and allotments are made until the total amount is distributed, with all counterparties paying their respective bid price. Such loans also must be 100% collateralised.

Norges Bank has primarily granted "F-loans" to financial institutions rather than longer-term repo operations, following previously unsuccessful attempts to encourage the use of repo facilities in the past. F-loans are provided for a number of different maturities, much like the longer-term ECB-refinancing operations. Longer maturity F-loans were provided during the credit crunch; these even included the provision of a 3-year F-loan by the Norges Bank in February 2009.

The collateral set eligible for short-term "D-loans" at Norges Bank is identical to that for the longer-term "F-loans" as Norges Bank only uses one collateral set for all its operations. Its collateral rules group different securities into various liquidity categories, much like the ECB (see below for further detail on these).

Covered bonds and other collateral eligible for Norges Bank repo operations

In order to be eligible as collateral, securities must be listed on Norges Bank's website and have to fulfill the following eligibility criteria:

Type and Jurisdiction:

> Bonds, notes and short-term paper issued by Norwegian and foreign issuers;

> Securities issued outside the EEA may be accepted provided that Norges Bank has legal confirmation that there are no problems associated with the realising of the collateral;

> Norwegian bond and money market funds (confined to investing in bonds, notes and short-term paper) are eligible as collateral provided that they are managed by a management company registered in Norway whose unit holdings are registered with the VPS and that Norges Bank has access to price information from Oslo Børs Informasjon.

Credit rating:

> Securities issued by foreign issuers and bonds, notes and short-term paper issued by Norwegian private entities are subject to credit rating requirements.

- Covered bonds issued under Norwegian law are exempt from the rating requirement if they are backed by domestic mortgage loans. For securities issued by Norwegian entities a credit rating of the issuer is sufficient.
- Norges Bank accepts credit ratings from S&P, Fitch and Moody's. A best rating approach is used, i.e. a satisfactory credit rating from just one of these three agencies is sufficient. The lowest acceptable credit rating for bonds with foreign issuers is A/A2, while the lowest acceptable credit rating for bonds issued by Norwegian issuers is BBB-/Baa3[17]

Listing:

Securities issued by private entities are subject to listing requirements.

- Private securities must be pledged in the VPS, must be listed on a stock exchange or other market place approved by Norges Bank.
- Securities pledged as collateral in another securities depository approved by Norges Bank must be listed on a stock exchange.
- The listing requirement does not apply to notes and short-term paper.

Requirements relating to minimum volume outstanding:

Securities issued by private entities are subject to requirements relating to minimum volume outstanding:

- Securities in NOK must have a minimum outstanding volume of NOK 300 m, whilst securities in a foreign currency must have a minimum volume equivalent to EUR 100 m.
- If a security issued by a private entity is denominated in a foreign currency, a bank may not pledge more than 20% of the loan's outstanding volume to Norges Bank. The same applies to Asset-Backed Securities (ABS) denominated in NOK.

Currency Restrictions:

- Securities shall be denominated in NOK, SEK, DKK, EUR, USD, GBP, JPY, AUD, NZD or CHF.

Multilateral development banks, government-guaranteed and regional debt securities:

- The Norges Bank may, subject to an assessment, exempt securities with irrevocable and unconditional government guarantees from the listing and minimum outstanding volume requirements. Subject to an assessment, Norges Bank may also permit a bank to collateralise more than 20% of the outstanding volume of a security of this type.
- Subject to an assessment, Norges Bank may grant the equivalent exemption for securities issued by regional or local authorities or multilateral development banks, as well as for government-guaranteed securities. These securities must then have a risk weighting of 0% in accordance with the capital adequacy requirements.
- In the case of government-guaranteed securities and securities issued by regional or local authorities or multilateral development banks, Norges Bank may, subject to an assessment, accept a credit rating provided by the issuer or the government guarantor.

17 The lowest acceptable credit rating for notes and short-term paper issued by foreign entities is A-1 from S&P or the equivalent rating from Fitch or Moody's, while the lowest acceptable credit rating for notes and short-term paper from Norwegian issuers is A-3 from S&P or the equivalent rating from Fitch or Moody's.

ABS and Other Restrictions:

> Asset Backed Securities (ABS) must have a AAA credit rating from S&P, Fitch or Moody's at the time of collateralisation and must be assessed by Norges Bank as what are termed "true sale" ABSs and must not be secured on commercial property loans.

> Only the upper tranche will be accepted as collateral and the borrower cannot pledge more than 20% of the volume outstanding of any deal.

> An ABS may be rejected if the pledging bank has close ties to the special purpose vehicle of an ABS (for example in the form of agreements on interest rate or currency swaps, lines of credit or the servicing of loans)

> Collateralised debt obligations (CDOs) are not eligible as collateral.

> Unsecured securities issued by banks and other financial institutions, or unsecured bonds issued by companies where banks or other financial institutions indirectly or directly own more than 33% are not eligible. Securities that are directly or indirectly linked to credit derivatives and zero-coupon bonds with a residual maturity of more than 7 years are not eligible as collateral. Nor will instruments such as convertible bonds, inflation-linked bonds, inverse floating rate bonds, FRN Caps or subordinated loans be eligible.

Own-name covered bonds:

A bank may pledge covered bonds and ABS as collateral even if the securities are issued by the bank itself or by an entity that is part of the same corporate group as the bank. Own-name covered bonds are subject to an additional haircut of 5%.

Haircuts:

The haircuts applied to the market value of a security are set out by category below:

> NORGES BANK HAIRCUTS BY CATEGORY AND RESIDUAL MATURITY (% OF MARKET VALUE)

Liquidity Category	Liquidity Category I		Liquidity Category II		Liquidity Category III		Liquidity Category IV	
Eligible Collateral	> AAA rated Government Bonds > Money market and bond funds confined to investments in the above securities		> Government bonds rated AA+ to A > Covered bonds rated AAA to AA- > Norwegian local government paper > Foreign local government paper rated A or better > 0% RW paper > Government-guaranteed paper > AAA rated corporates		> Covered bonds rated A+ to A > Corporate bonds rated AA+ to A > Units in eligible money market and bond funds		> Norwegian covered bonds rated A- or lower and unrated > Norwegian corporate bonds rated A- to BBB-	
Maturity	Fixed	Floating	Fixed	Floating	Fixed	Floating	Fixed	Floating
0-1 year	1.0	1.0	3.0	3.0	4.0	4.0	8.0	8.0
1-3 years	3.0	1.0	5.0	4.0	6.0	5.0	11.0	10.0
3-7 years	5.0	1.0	7.0	5.0	10.0	7.0	17.0	14.0
7+ years	7.0	1.0	10.0	6.0	13.0	9.0	22.0	17.0

Source: RBS, Norges Bank

Securities in foreign currencies and own-name covered bonds are subject to a further 5% haircut. ABS are subject to a 15% haircut, regardless of maturity. Additional haircuts apply on FRNs if no price information is available.

Temporary monetary policy operations: a unique swap arrangement

Another monetary policy instrument used by Norges Bank, which is somewhat unique in the context of covered bonds, is a swap arrangement where banks could swap covered bonds in return for government securities. The arrangement was put in place in November 2008 for NOK 230 bn. The maturity of the swaps was originally three years but was subsequently extended to five years. In December 2009 auctions were cancelled until further notice.

Access to Norges Bank lending facilities by covered bond mortgage companies

In a statement published in May 2013, Norges Bank argues that "covered bond mortgage companies should not be given general access to the central bank lending facility" since "the granting of liquidity loans is expressly restricted to commercial banks and savings banks." It has to be noted however that "Norges Bank's ability to extend liquidity support to financial institutions in extraordinary cases is not limited by whether the institution has ordinary access to the lending facilities."

6. AUSTRALIA: ELIGIBILITY CRITERIA FOR RESERVE BANK OF AUSTRALIA (RBA) OPERATIONS

The Reserve Bank of Australia (RBA) expresses its desired stance of monetary policy through the operating target for the cash rate, the money market rate on overnight interbank funds. The RBA targets this through its short-term open-market operations ("domestic market operations"). The same collateral set is also applicable to the longer-term operations provided.

Covered bonds and RBA eligible collateral

In order to be considered as eligible collateral by the RBA, all securities, including covered bonds, must fulfil the following criteria:

> **Currency:** The security is denominated in Australian dollars and traded in Austraclear. The RBA will not accept securities that trade as Euro-entitlements.

> **Rating:** The lowest credit rating assigned to a security or its issuer by any of the major rating agencies will be used to assess eligibility and eventual haircut. For covered bonds only security ratings are considered as long as at least two ratings are available. Otherwise minimum issuer ratings will also be considered.

> **Structured bonds**: Highly structured securities or those with embedded derivatives are not eligible.

> **Own name bonds:** Securities issued by the bank itself or related entities are not eligible. A related party is deemed to be an institution that has a significant relationship to the credit quality of the security and so includes (but is not restricted to) the loan originator, swap counterparties and liquidity providers[18]. This 'related party exemption' also applies to covered bonds and as such "own name covered bonds" are not eligible for RBA repo operations.

RBA Repos

When the RBA buys securities under repurchase agreement it does so in two broad classes of securities: General Collateral and Private Securities. Since the mid 1990s, the RBA has gradually widened the range of highly-rated securities that it is prepared to accept in response to the decline in available government debt and taking into account the changing structure of financial markets.

In February 2012 the RBA changed the range of securities eligible for its repos. The only change pertained to the eligibility of securities issued by authorised deposit-taking institutions (ADIs) where the rating requirements were lowered. The current set of eligible securities and the respective minimum rating requirements are given below:

18 An exception applies in extraordinary circumstances when the RBA may accept related party RMBS or ABCP

	Minimum Rating
General Collateral	
A$ Commonwealth Government Securities	n/a
A$ Semi-governments Securities	n/a
A$ Domestic Issues by Supranationals and Foreign Governments	A-1 or AAA*
A$ Securities with an Australian Government Guarantee	n/a
A$ Securities with a Foreign Sovereign Government Guarantee	A-1 or AAA*
Private Securities	
Securities (including Covered Bonds) issued by authorised deposit-taking institutions (ADIs)	
Residual maturity of 1Y or less	Any public rating
Residual maturity > 1Y	At least two ratings, the lowest being at least BBB+
Asset Backed Securities	
Standard	A-1 or AAA
Other	A-1 or AAA
Other Securities	A-1 or AAA

* Minimum rating requirement waived for securities issued and/or guaranteed by the New Zealand government

This mainly comprises covered bonds denominated in AUD and issued in the Kangaroo market (i.e. onshore) to be eligible for Repo transactions with the RBA. The RBA is willing to accept "other AAA assets" which include covered bonds, as well as senior unsecured bank debt as long as it is rated AAA and denominated in AUD. The RBA accepts both legislative and structured covered bonds. As it is the case with all central banks, the RBA retains the right to reject any particular security or securities from any issuer and specifically stated that it will not accept "highly structured" securities. This does not apply to covered bonds, but rather to CDOs or other such structures.

7. NEW ZEALAND: ELIGIBILITY CRITERIA FOR RESERVE BANK OF NEW ZEALAND (RBNZ) OPERATIONS

RBNZ monetary policy operations

Since March 1999 the RBNZ implements monetary policy by setting the Official Cash Rate (OCR), which is reviewed eight times a year. The monetary operations of New Zealand are composed of (a) Liquidity Operations, (b) Standing Facilities and (c) Other Domestic Operations. The Open Market Operations (OMO) of the Reserve Bank of New Zealand (RBNZ), including overnight repo transactions and issuance of RBNZ bills (to remove unwanted liquidity) fall within the "Liquidity Operations", as do the FX Swaps and Basis Swaps operations provided. The Standing facilities are made up of the Overnight Reverse Repo Facility and a Bond Lending Facility. Finally "Other Domestic Operations" consist of the repurchase or swapping of New Zealand government securities.

The following securities are eligible for the RBNZ's overnight repo transactions within the Liquidity Operations and the Bond Lending Facilities (part of the Standing facilities):

- New Zealand Government Treasury bills;
- New Zealand Government bonds;
- New Zealand Government inflation-indexed bonds; and,
- Other (non-New Zealand Government Securities) as approved by the RBNZ.

Covered bonds potentially fall within this final definition, as long as they comply with the eligibility criteria. These are set out in the section below.

Covered bonds are not eligible for other RBNZ monetary operations. The eligibility of securities for the 'Overnight Reverse Repo' under the RBNZ Standing Facilities is restricted solely to New Zealand Government bonds, Treasury bills and RBNZ bills. For the "Other Domestic Operations", the RBNZ from time to time offers to either repurchase and/or swap New Zealand Government securities. The RBNZ announces its intention to repurchase and/or swap the relevant securities via the electronic media and the conditions applying to the operation are included. Purchases may be for the RBNZ's own account or on behalf of the Crown.

Covered bond eligibility for RBNZ operations

As explained above, covered bonds are eligible for the RBNZ's overnight repo transactions within the Liquidity Operations and the Bond Lending Facilities, as long as they fit the following criteria:

Rating:

> Issues are rated AAA by at least two acceptable rating agencies. In case of more than two issue ratings, at least two agencies must rate the issue as AAA, and no rating should be lower than AA+.

> The issuer has a credit rating from at least two acceptable rating agencies.

Cover Pool:

> The cover pool must be comprised of New Zealand originated first registered mortgages on New Zealand residential properties.

> The mortgage collateral is owned by a special purpose vehicle (SPV) that is bankruptcy remote from the originator.

> The loan to value ratio for each individual mortgage does not exceed 80%.

> Mortgages with loan to value ratios that exceed the 80% level will be removed from the cover pool and replaced with qualifying mortgages.

> Only loans that are performing have been included in the pool (non-performing loans are defined as those that are 90 days or more past due).

> "Asset monitors" independent from the trustee and the originator verify calculations relating to asset coverage tests and any other key ratios and provide these, and any other relevant reports, to the RBNZ on a regular basis.

Price Sources:

> Covered bond pricing is available on at least 80% of days via the NZFMA's NZ Credit Market Daily Pricing Service. Pricing is available at all month-ends.

Currency:

> Issues are denominated in New Zealand dollars (NZD only).

Settlement:

> Covered bonds are lodged and settled in NZClear. Eligibility criteria for lodgement into NZClear include having a suitable registrar, and paying agent.

Own-name bonds:

> Covered bonds are repo eligible on a two-name basis only, thus removing the possibility of issuers posting 'own-name' covered bonds to the RBNZ.

Of course, as is the case for all central banks, the RBNZ reserves the right to refuse an asset for any reason and is not required to disclose such reasons. In particular, "it should be noted that if the credit rating of the issue falls below the Reserve Bank's threshold, then the issue will cease to be eligible in the Reserve Banks' operations."

Thus, the RBNZ applies relatively strict criteria in setting eligibility for covered bonds, in particular the requirement that the cover pool can only comprise of New Zealand originated first registered mortgages on New Zealand residential properties currently restricts the use of the repo facility to covered bonds issued by domestic banks (or New Zealand subsidiaries of foreign banks using domestic loans). Nonetheless, if a foreign issuer were to have eligible loans in the pool (and fulfill all the other criteria), their covered bonds could also be eligible. Covered bonds are also subject to the strict requirement of being NZD-denominated, consistently with the rules for all other securities except for those guaranteed by the NZ government; even bonds issued or guaranteed by foreign governments must be NZD-denominated. Therefore, US Treasuries or Bunds in their domestic currencies would technically not be eligible for the RBNZ's operations.

The full haircuts matrix can be found below. It shows that NZD Covered bonds receive relatively benign haircuts, in line with two-name basis NZD-denominated RMBS, but significantly better than single-name RMBS, and everything else, apart from AAA bank and corporate debt and state-owned enterprise bonds. In fact, the haircut of 5% for securities below 3-years is even lower than the 6% haircut applied to NZD-denominated government guaranteed securities. In effect only Kauri and New-Zealand government securities (and RBNZ bills) receive lower haircuts. Ultimately, the eligibility criteria for repo are strict but eligible covered bonds receive highly favourable treatment.

Eligible Security	**Minimum Rating**	**Haircut**	
		< 3 years	**≥ 3 years**
NZ Government & RBNZ			
Treasury Bills	AA+	1%	3%
Bonds			
Inflation-linked Bonds			
RBNZ Bills	n/a	1%	3%
Acceptable Kauri issues (NZD)	AAA	3%	5%
	AA-	6%	8%
	A-	10%	15%
Bank Securities (NZD)			
Bank bonds - NZ Registered Banks only	AAA	5%	8%
	AA-	8%	10%
	A-	10%	15%
	BBB-	15%	20%
NZ Registered Bank RCD's	A-1+	10%	n/a
	A-1	15%	n/a
	A-2	20%	n/a

Eligible Security	Minimum Rating	Haircut	
		< 3 years	≥ 3 years
Local Authorities (NZD)			
Bonds	AAA	5%	8%
	AA-	8%	10%
	A-	10%	15%
	BBB-	15%	20%
CP	A-1+	10%	n/a
	A-1	15%	n/a
	A-2	20%	n/a
State-Owned Enterprises (NZD)			
Bonds	AAA	5%	8%
	AA-	8%	10%
	A-	10%	15%
	BBB-	15%	20%
CP	A-1+	10%	n/a
	A-1	15%	n/a
	A-2	20%	n/a
Corporate Securities (NZD)			
Bonds	AAA	5%	8%
	AA-	8%	10%
	A-	10%	15%
	BBB-	15%	20%
CP	A-1+	10%	n/a
	A-1	15%	n/a
	A-2	20%	n/a
Securities guaranteed by NZ government			
NZD Denominated	AA+	6%	8%
	A-1+		
Non-NZD Denominated	AA+	11%	13%
	A-1+		
Securities issued/guaranteed by Foreign governments (NZD)			
Bonds	AA+	6%	8%
CP			
RMBS (NZD- on a two name basis)			
Bonds	AAA	5%	8%
CP			
RMBS (NZD- on a single name basis)			
Bonds	AAA	19%	
CP			
Covered Bonds (NZD)			
Bonds	AAA	5%	8%

8. CANADA: ELIGIBILITY CRITERIA FOR BANK OF CANADA MARKET OPERATIONS

The Bank of Canada uses a number of permanent facilities to conduct market operations:

> **SPRA/SRAs:** The Bank conducts Special Purchase and Resale Agreements (SPRAs) and Sale and Repurchase Agreements (SRAs) to implement its monetary policy framework in the LVTS environment. SPRAs and SRAs are used to reinforce the target overnight rate at the mid-point of the operating band.

> **Overnight Standing Purchase and Resale Agreement:** The Bank makes this standing facility available to Primary Dealers on an overnight basis at the upper limit of the operating band (Bank Rate).

> **Term Repo for Balance Sheet Management Purposes:** The Bank may acquire assets temporarily in the secondary market to manage short-term changes in the Bank's balance sheet, which is typically due to seasonal fluctuations in the demand for bank notes.

> **Securities Lending Program:** The Bank supports the liquidity of Government of Canada securities by providing a secondary and temporary source of securities to the market through a tender process for a term of one business day.

> **Standing Liquidity Facility:** The Bank of Canada provides Large Value Transfer System (LVTS) advances, which are collateralised overnight loans to direct participants in the LVTS. The same assets eligible for the Bank's Standing Liquidity Facility (SLF) are also eligible to obtain intraday liquidity for participants in the LVTS.

> **Bank of Canada Margin Call Practice for Domestic Market Operations:** For transactions outstanding against securities purchased or sold under a term purchase and resale agreement, the Bank values the securities daily, and compares that value to the contract valuation in order to ensure the Bank is adequately protected. The Bank may initiate a margin call, requesting the counterparty to deliver additional securities to cover any shortfall.

The Bank of Canada provides access to liquidity, through its Standing Liquidity Facility (SLF), to those institutions that participate directly in the Large Value Transfer System (LVTS). Under the provisions of the Bank of Canada Act, the Bank's LVTS advances (commonly referred to as overdraft loans) are required to be made on a secured basis. The collateral used to secure these advances must be acceptable to the Bank of Canada, and an appropriate margin is applied to reflect various risk factors. Notwithstanding the eligibility criteria listed below, the Bank of Canada retains the right of refusal for any asset, or for any programme from which securities are issued.

In December 2012, the Bank of Canada added Canadian covered bonds as eligible assets to the list of collateral which can be pledged under its Standing Liquidity Facility. The covered bonds have to fulfill the following criteria and conditions:

> Only covered bonds from programmes that are registered with the Covered Bond Registrar (CMHC) and are compliant with the federal legislative framework for covered bonds are eligible, i.e. Canadian covered bonds.

> The issuer must have a minimum of two credit ratings from two major credit rating agencies, the second highest of which is at least A(low) by DBRS, A- by Fitch, A3 by Moody's, or A- by S&P.

> Eligibility is restricted to covered bonds denominated in Canadian Dollars. This requirement is not limited to covered bonds but is applicable to all asset classes with the exception of US Treasuries denominated in US dollars.

> Covered bonds will count towards the existing 20% issuer concentration limits.

> Pledgors of collateral will not be able to submit as collateral their own covered bonds.

> Haircuts will be based on the second-highest issuer credit rating.

> Haircuts for various Asset Classes and Maturity Brackets

Collateral type	up to 1 year	>1-3 years	>3-5 years	>5-10 years	>10-35 years	>35 years
Securities issued by the Government of Canada	0.5%	1.0%	1.5%	2.0%	2.5%	
Government of Canada - stripped coupons and residuals	0.5%	1.0%	1.5%	2.0%	3.0%	
Securities guaranteed by the Government of Canada (including Canada Mortgage Bonds and NHA mortgage-backed securities)	1.0%	1.5%	2.0%	2.5%	3.5%	
Government of Canada guaranteed - stripped coupons and residuals	1.0%	1.5%	2.5%	4.0%	4.5%	
Securities issued by a provincial government	1.5%	2.0%	2.5%	3.0%	4.0%	4.5%
Provincial government – stripped coupons and residuals	1.5%	2.0%	3.0%	4.5%	6.0%	14.5%
Securities guaranteed by a provincial government	2.0%	2.5%	3.0%	3.5%	4.5%	5.0%
Provincial government guaranteed – stripped coupons and residuals	2.0%	2.5%	3.5%	5.0%	6.5%	15.0%
Securities issued by a municipal government minimum rating by DBRS: R-1(mid) / AA(low) Fitch: F-1+ / AA- Moody's: Aa3 S&P: A-1+ / AA-	2.5%	3.0%	3.5%	4.0%	5.0%	5.5%
Securities issued by a municipal government minimum rating by DBRS: R-1(low) / A(low) to A(high) Fitch: F-1 / A- to A+ Moody's: P-1 / A3 to A1 S&P: A-1 / A- to A+	4.5%	5.0%	5.5%	6.0%	7.0%	7.5%
Bankers' acceptances, promissory notes, commercial paper, including those of foreign issuers rated by DBRS: R-1(mid) or better Fitch: F-1+ S&P: A-1+	3.0%					
Bankers' acceptances, promissory notes, commercial paper, including those of foreign issuers rated by DBRS: R-1(low) Fitch: F-1 Moody's: P-1 S&P: A-1	5.0%					

Collateral type	up to 1 year	>1-3 years	>3-5 years	>5-10 years	>10-35 years	>35 years
Asset-backed commercial paper (minimum of two ratings: R-1(high) by DBRS, F-1+ by Fitch, P-1 by Moody's, or A-1+ by S&P)	7.5%					
Covered bonds (based on issuer rating) rated by DBRS: AA(low) or better Fitch: AA- or better Moody's: Aa3 or better S&P: AA- or better	3.0%	3.5%	4.0%	6.5%	8.5%	9.0%
Covered bonds (based on issuer rating) DBRS: A(low) to A(high) Fitch: A- to A+ Moody's: A3 to A1 S&P: A- to A+	5.0%	5.5%	6.0%	8.5%	10.5%	11.0%
Corporate and foreign-issuer bonds rated by DBRS: AA(low) or better Fitch: AA- or better Moody's: Aa3 or better S&P: AA- or better	3.0%	3.5%	4.0%	6.5%	8.5%	9.0%
Corporate and foreign- issuer bonds rated by DBRS: A(low) to A(high) Fitch: A- to A+ Moody's: A3 to A1 S&P: A- to A+	5.0%	5.5%	6.0%	8.5%	10.5%	11.0%
Securities issued by the United States Treasury**	1.0%	1.0%	1.5%	3.0%	4.5%	

* For securities with a remaining maturity of up to one year, margins are adjusted by term divided by 365.
** An additional 4% (not adjusted for term divided by 365) will be added to the margin requirements for securities issued by the US Treasury to account for foreign exchange risk.

The following conditions are applied when using as collateral the assets listed above:

(i) **Only CAD-denominated assets are eligible** to be pledged as collateral, with the exception of securities issued by the United States Treasury in USD.

(ii) Securities used as collateral must be pledged using CDSX of CDS Clearing and Depository Services Inc., or be physically delivered to the Bank in certificated form.

(iii) No more than 20% of the total value of the collateral pledged by an institution may be the obligation of a single corporate (including covered bonds), municipal or foreign private sector issuer, or related party. In the case of ABCP, no more than 20% of the value of the collateral pledged by an institution may be ABCP sponsored by a single institution[19].

19 This condition does not apply for borrowings of less than CAD 50 m.

COVERED BONDS AND REPOS: CONCLUSION

The comparison of the various treatments of covered bonds by some of the major central banks underlines the special status of covered bonds. This is driven in our opinion by the macro-economic benefits of covered bonds through the provision of cheap residential (and commercial) mortgages and by giving banks a stable and relatively low-cost additional funding channel. However, there is not one uniform approach and the stances towards covered bonds of the various central banks differ considerably. As already indicated in the introduction, broadly speaking covered bonds receive more favourable treatment amongst those countries in which they play a more pivotal role in the funding of the domestic banking sector. This applies primarily in terms of eligibility of covered bonds as collateral for repo operations, but also in terms of the haircuts.

2.4 COVERED BONDS VS. SENIOR UNSECURED BANK DEBT AND RMBS

2.4.1 COVERED BONDS VS. RMBS

By Bernd Volk, Deutsche Bank

COVERED BONDS ARE AN ON-BALANCE SHEET FUNDING TOOL

The boundaries between covered bonds and Mortgage Backed Securities (MBS) were in certain instances starting to become blurred before the crisis. However, in case of covered bonds, all outstanding covered bonds by one issuer are typically backed by all loans in the cover pool. In contrast to MBS, there is no connection between a specific cover asset and outstanding covered bonds. In case of issuer insolvency no further assets will typically be added to the cover pool - i.e. the cover pool administrator loses the capability to bring in sufficient new assets in order to comply with the coverage regulations. As long as the issuer is solvent, the issuer manages the cover pool and can take in and out cover pool assets.

IN CONTRAST TO MBS, COVERED BONDS ARE BANK BONDS

A crucial difference between covered bonds and MBS is that covered bondholders have recourse against the bank and the preferential access to the cover pool of underlying assets. In case of MBS, cover assets are transferred to a SPV, investors have no recourse to the issuer and are usually exposed to prepayment or other option risks. MBS proponents typically 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 bank credit quality will also worsen. However, cover pool assets are typically the highest credit quality assets on the bank balance sheet. Moreover, in case bank credit quality worsens, the issuing bank (or the parent company) might receive external support by its banking group or public sector entities or, at least, another bank might be interested in the high quality cover pool assets. In case there is no support for the bank, the segregation of cover pool assets and payment of covered bonds might be (at least) protected by liquidity support.

Because covered bonds are obligations of the issuing bank and, in addition, are backed by an underlying cover pool of high quality assets, covered bonds are less risky as the issuing bank and the cover pool on a separate basis. In case of MBS, the risks of senior tranche holders are only mitigated by subordinate tranches and various further structural features. Covered bonds typically have fewer of additional structural protections and rely on certain matching rules and over-collateralisation (OC). Legal framework based covered bonds are subject to stringent specific legal frameworks (e.g., stipulating asset eligibility criteria and maximum LTV ratios). Overall, covered bonds typically benefit from significantly lower complexity compared to MBS.

Regulated Covered Bonds	RMBS
> Issuer: Credit institutions > Servicing relationship is unaffected as the originator (or the respective banking group) are responsible for servicing > Specific legal framework and specific supervision > Issuance license needed Dual claim against bank and cover pool assets Recorded on the liability side of the issuer as liability of the loan originator or covered bond issuer > Eligibility criteria regarding cover pool assets in specific legal framework > ECB eligible, minimum rating BBB-, haircut depends on term to maturity but is significantly lower than in case of RMBS > Basel III LCR: Level 2A assets: covered bonds rated AA- and better with 15% haircut (not issued by the bank itself) > CRR/CRD4 even allows covered bonds to be considered as level 1 assets (depending on certain criteria regarding liquidity and credit quality)	> Issuer: SPV > Originator can service the loans under contract but servicing is an independent relationship > Contractual framework, no specific supervision > No issuance license needed Claim against assets in the SPV Usually not recorded on the liability side of the balance sheet of the originator or issuer > Specific to each transaction, no general eligibility criteria > ECB eligible, 26% haircut in case of BBB rated RMBS > Basel III LCR: RMBS as Level 2B assets > Level 2B: Including qualifying RMBS rated AA and better with 25% haircut (not originated by the bank itself); see further details below

The narrow scope of assets eligible for covered bond cover pools ensures that only extremely high quality assets are included, i.e. it does not allow to structure higher risk products, like for example, UK non-conforming RMBS. Overall, covered bonds are inherently structured to achieve maximum safety for investors. In contrast to covered bonds, MBS can be used to transfer credit risk to capital markets, credit risk that can be significant for investors.

COVERED BONDS HAVE TYPICALLY A LONGER MATURITY THAN MBS

As covered bonds typically have a fixed rate bullet structure, the cover pool has to be constantly "refilled", i.e. mortgage loans becoming due have to be reinvested. This can lead to higher credit and market risk in the cover pool compared to triple senior 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, 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), the management of the interest rates risks between the fixed rate covered bonds and (often) variable rate mortgage loans, and typically the need to sell cover assets in case of issuer insolvency to pay covered bonds with bullet maturities. As a result of the dynamic pool, covered bonds typically have a longer maturity than MBS.

MATURITY EXTENSION AS MAIN RISK OF RMBS

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

One of the risks of MBS, in sharp contrast to covered bonds, is (significant) maturity extensions. MBS prepayment varies from jurisdiction to jurisdiction. The UK is predominantly characterised by Master Trusts, which rely upon high prepayment rates to meet scheduled maturities. Sponsors have however injected assets into trusts, issued further bonds or purchased notes in order to meet scheduled redemptions. MBS from Ireland, Portugal and the Netherlands will typically rely upon varying degrees of prepayment and sponsor call. Lower prepayment rates along with the lack of fully functioning debt capital markets have meant extension risk has become a core consideration in European RMBS.

In case of covered bonds, increasing non-performing loans in the cover pool are a negative indicator regarding issuer credit quality. The issuer typically takes out non-performing loans (i.e. keeps the cover pool clean). In most countries, issuers are even obliged to do so by law. When non-performing loans in the cover pool increase, it suggests that the issuer is no longer able to support the cover pool, in turn, indicating declining issuer credit quality. However, in case non-performing loans increase, the overall credit quality of covered bond pools (also due to additional protection provided by a "low LTV- mortgage") is typically very strong.

OC OF COVERED BONDS TYPICALLY MUCH BIGGER THAN SUBORDINATION OF MBS

Typically, OC requirements of rating agencies to achieve certain ratings are much higher for covered bonds than for senior RMBS tranches. This is mainly due to covered bonds facing not only credit risk but also market risks, due to typically high mismatches between cover pool assets and outstanding fixed bullet covered bonds. It seems rating agencies focussing too much on so-called refinancing risk, which in practice is typically significantly lower.

VOLUME OF OUTSTANDING RMBS DECLINING STRONGLY

Taking a look at outstanding RMBS volumes per country (see below) compared with the volume of outstanding covered bonds, presented in the 2012 ECBC Factbook, shows that the Netherlands, UK and Italy have relatively large RMBS markets compared to respective covered bond markets. On the other hand, with only EUR 21.7 bn and EUR 29.2 bn of RMBS as of Nov 2012 respectively, Germany and France are clearly dominated by covered bonds.

A different historical development is crucial in this respect. Due to lack of investor demand, the outstanding volume of RMBS declined strongly in the recent past. For example, the volume of prime UK RMBS declined from EUR 255.6 bn in Nov 2011 to EUR 220.9 bn in Nov 2012. Also the volume of Spanish RMBS declined from EUR 145.4 bn in Nov 2011 to EUR 105 bn in Nov 12 and the volume of Italian RMBS declined from EUR 119.3 bn in Nov 2011 to EUR 83.4 bn in Nov 2012. Due to different regulatory treatment for RMBS (for example higher risk weights, higher Solvency 2 capital charges and higher ECB haircuts) but also generally lower investor demand, a further decline of the outstanding volume of RMBS seems unavoidable.

Table 1: Outstanding volume of RMBS per countries

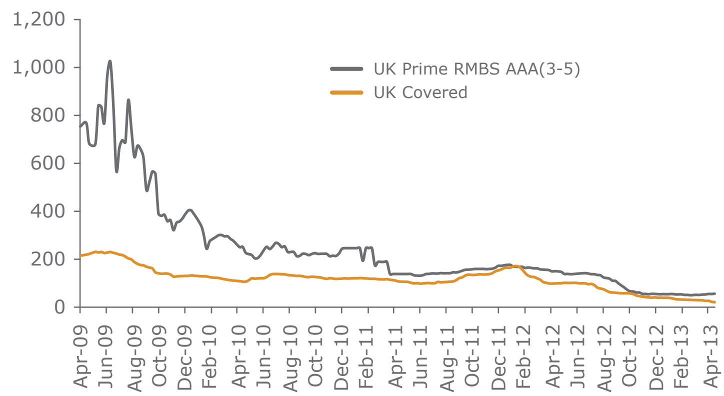
Country	Outstanding Volume (EUR bn) Nov 2012	Outstanding Volume (EUR bn) Nov 2011
Belgium	65.4	64.3
France	29.2	26.8
Germany	21.7	26.3
Greece	2.7	3.4
Ireland	48	50.6
Italy	83.4	119.3
Netherlands (Prime)	220.9	255.6
Netherlands (NHG)	42.3	43.7
Portugal	18.7	21.1
Spain	105	145.4
UK (Prime)	216.1	303.8
UK (Non-Conforming)	20.3	21.7
UK (Buy-to-let)	25.2	37.6

Source: Moody's

Generally, as covered bonds are bank bonds, regulatory changes regarding banks relating to capital, liquidity buffers, Net Stable Funding Ratio (NSFR), risk weighting and leverage are likely to make banks fundamentally stronger which in turn supports the credit quality of covered bonds.

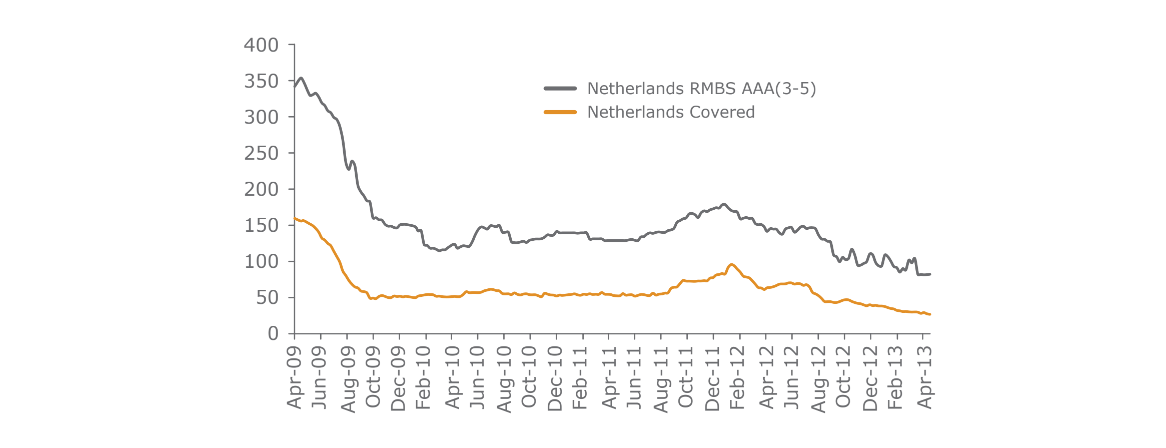
Stronger structural and asset quality features and typically a significantly lower structural complexity compared to RMBS are reasons for covered bonds outperforming MBS at the beginning of the financial market crisis. Given the overall trend to simpler structures and less contractual complexity in financial markets in general, covered bonds seem well positioned in this respect. At the end of the day, covered bonds are bank bonds, additionally protected by extremely high quality assets. The preferential claim on the cover pool is an add-on, something which may be valued more or less by investors.

> Figure 1: UK RMBS (DM) versus UK covered index (ASW spread)



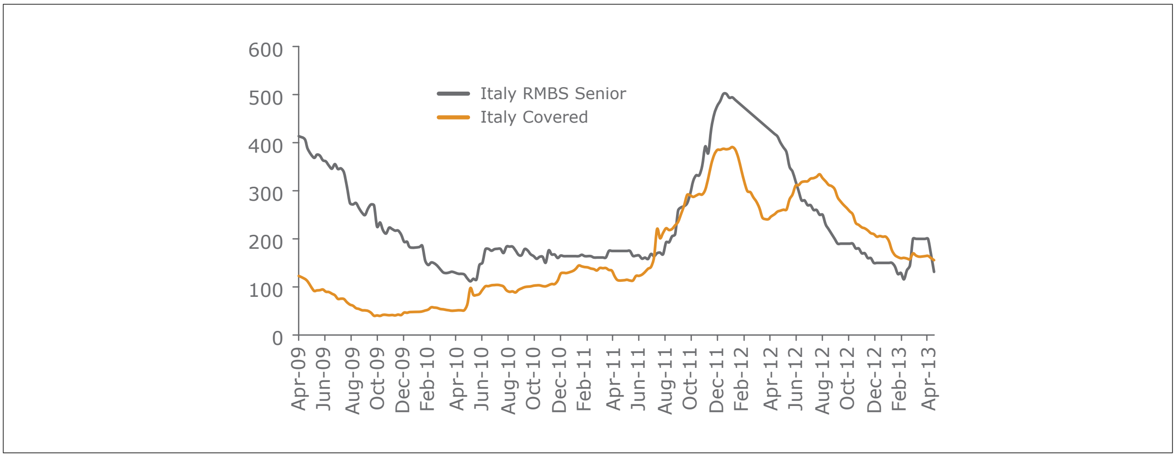
Sources: Markit, Deutsche Bank

> FIGURE 2: NETHERLANDS RMBS (DM) VERSUS DUTCH COVERED INDEX (PAR ASW)



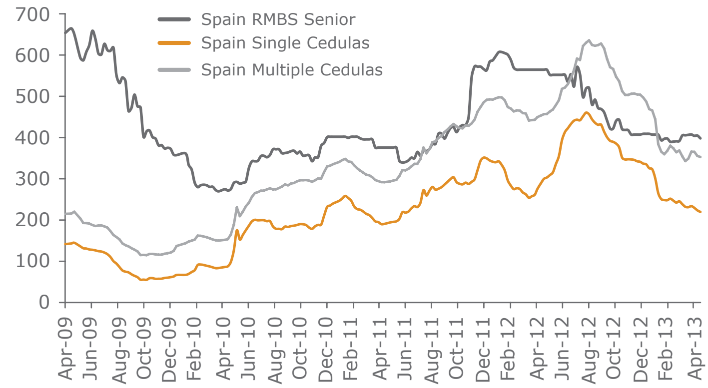
Sources: Markit, Deutsche Bank

> FIGURE 3: ITALY RMBS (DM) VERSUS ITALY COVERED INDEX (PAR ASW)



Sources: Markit, Deutsche Bank

> FIGURE 4: SPAIN RMBS (DM) VERSUS SPAIN COVERED INDEX (PAR ASW)



Sources: Markit, Deutsche Bank

LIQUIDITY COVERAGE RATIO

RMBS are eligible as LCR Level 2A and 2B assets

Covered bonds as Liquidity Coverage Ratio (LCR) assets are described in the ECBC Fact Book. Below, we shortly describe the treatment of RMBS as LCR assets under Basel III. The aim of the so-called Basel III LCR is to ensure that a bank has an adequate stock of unencumbered High Quality Liquid Assets (HQLA) that consists of cash or assets that can be converted into cash at little or no loss of value to meet its liquidity needs for a 30 calendar day liquidity stress scenario.

The announcements of the Basel Committee for Banking Supervision on 6 and 7 January 2013 mean that the stock of HQLA is divided into two classes: Level 1 which has no upper limit, Level 2 which has a cap of 40% of total HQLA. Level 2B is a subset of Level 2 which can comprise 15% of total HQLA. These proportions are calculated after appropriate haircuts to market value. Level 1 assets would be cash, central bank reserves, sovereign bonds of zero risk weight, and bonds from international agencies such as BIS, ECB or multilateral development banks.

Level 2A assets have a 15% haircut on the current market value and are either sovereign bonds, PSEs, multilateral bank bonds that are assigned 20% risk weight under Basel 2 standardised approach, and is not an obligation of a financial institution or any of its affiliated entities. The assets should be traded in large, deep, active repo or cash markets characterised by low concentration. The assets should be a reliable source of liquidity in stressed market conditions - max decline of price not exceeding 10% or increase in haircut not increasing 10%pts over a 30-day period of significant liquidity stress. Corporate debt (including CP) which are not financial debt and covered bonds of other banks would also qualify as Level 2A assets, but need to have a long term credit rating from a recognised agency of at least AA- (or equivalent short term or internal rating). Additionally they should be liquid - a maximum decline in price or increase in haircut over a 30-day period of stress not exceeding 10% is required. Level 2B assets will be included at the discretion of the national authorities.

In contrast to covered bonds (which are eligible for Level 2A), RMBS that are rated AA or higher (or equivalent short term rating) would qualify as a Level 2B asset with a 25% haircut. The underlying loans need to be full recourse loans and have a maximum average LTV of 80% at issuance. Note that the RMBS cannot be originated by the bank, so issuer retained senior tranches would not qualify towards LCR. In general, national supervisors would need to look at whether they would qualify RMBS as being traded in “large, deep and active” repo or cash market, "characterized by low concentration". RMBS would have to have a proven record as a reliable source of liquidity - during a stressed 30-day period, would need to not have a price decline exceeding 20% or increase in haircut beyond 20 percentage points. Risk retention regulation would need to apply to the securitization.

Additionally, Level 2B assets would also include non-financial corporate debt with a 50% haircut, that are rated between A+ and BBB- (long term, or equivalent short term or internal rating). Common equity shares that are liquid, not issued by a financial institution and are publicly traded would also qualify with a 50% haircut towards Level 2B assets.

Market impact likely limited

Despite the explicit recognition of RMBS as an eligible LCR asset, the market impact is likely to be limited. UK Prime is the most obvious asset class that would qualify, but given the spreads the bonds had at the time of the announcement, this was probably priced in already. Interestingly, perhaps unexpectedly, UK non-conforming senior RMBS and UK BTL would qualify as LCR candidates, albeit would require Bank of England approval.

The LTV restrictions under Basel III LCR would mean that most Dutch RMBS would not qualify at this stage. However, there are about 10 Dutch RMBS transactions where original LTV is less than 80% which could qualify towards LCR. Moreover, as this refers only to the BIS recommendation, the status of Dutch RMBS is not completely settled. Existing peripheral RMBS would largely get disenfranchised as LCR assets owing to the rating restriction, however exceptions exist. No existing Greek, Irish, Spanish and Portuguese RMBS would qualify but (at the time of the announcement) there were 22 investor placed Italian RMBS bonds that do qualify. The qualifying bonds had already limited rating cushion however – a further two notches S&P downgrade before 2015 would render them ineligible.

Additionally, Level 2B assets which comprise RMBS, corporate bonds (rated between A+ and BBB-) and certain equities would together be limited to 15% of the total stock of HQLA. In effect, RMBS would share the available 'quota' with other assets thereby limiting the impact, though the 25% haircut on RMBS is better than the 50% haircut on the other Level 2B eligible assets, so we expect RMBS to be favoured over competing asset classes.

COVERED BONDS ARE EXCLUDED FROM BAIL-IN

While bank bail-outs (also supporting covered bonds of respective banks) has occurred to date, given significant sovereign credit quality pressures, a key risk is the willingness and ability of governments to bail out banks. This is a risk for Lower Tier 2 and senior bonds. However, covered bonds rank highest regarding potential support, at least regarding liquidity, i.e. refinancing risk.

Product specific support for covered bonds is, besides others, confirmed for instance by the German Bank Restructuring Act which explicitly excludes Pfandbriefe from direct burden-sharing measures stipulated in case of a bank restructuring. The same will likely be the case in other EU countries and their UCITS compliant covered bonds under the upcoming the EU bank resolution regime. Under the draft version of the EU bank resolution regime published in June 2012 (with amendments published in Feb 2013), EU Member States can fully exempt UCITS compliant covered bonds from bail-in measures.

We expect that most (if not all) EU Member States will make use of the full exemption. In case the full exemption option is not used by the respective EU Member State, a market valuation of the cover pool is needed and only in case there is an under-collateralisation, bail-in of covered bonds can be considered by the resolution authority. However, at this stage, it seems unclear, how much OC will be included in the respective market valuation of the collateral.

CONCLUSION

Despite convergence of covered bonds and MBS pre-crisis, there are crucial differences between the two products. MBS investors are more exposed to the risk of underperformance of the cover pool and maturity extension. With the financial crisis, high non-performing loans and lower pre-payments are drivers of cover pool underperformance and maturity extensions of MBS. Covered bonds are bank bonds and covered bond-holders benefit from a preferential claim on a cover pool, the support of the issuing bank and every kind of external support provided to the issuing bank. Covered bondholders are not limited to cover pool assets and, hence, are not necessarily directly impacted by lower pre-payments or a worsening asset quality. While legal and regulatory sentiment remains adverse for MBS, covered bonds benefit from strong regulatory support. Given that the boundaries between MBS and covered bonds became blurred pre-crisis, at least in some areas, the ECBC Covered Bond Label is an initiative to clarify the differences and the strength of covered bonds in an objective and transparent way.

Mainly due to the fact that covered bond cover pools are dynamic and due to typically high asset liability mismatches between cover assets and outstanding covered bonds, OC requirements by rating agencies for covered bonds are much higher than credit enhancements for senior tranches of MBS, in turn leading to strong investor protection. Even taking into account that systemic support for banks will clearly decline going forward, systemic support for covered bonds will likely remain high. In this respect, probably most EU Member States will fully exempt UCITS compliant covered bond from bail-in, confirming the specific role of UCITS compliant covered bonds in the EU financial market.

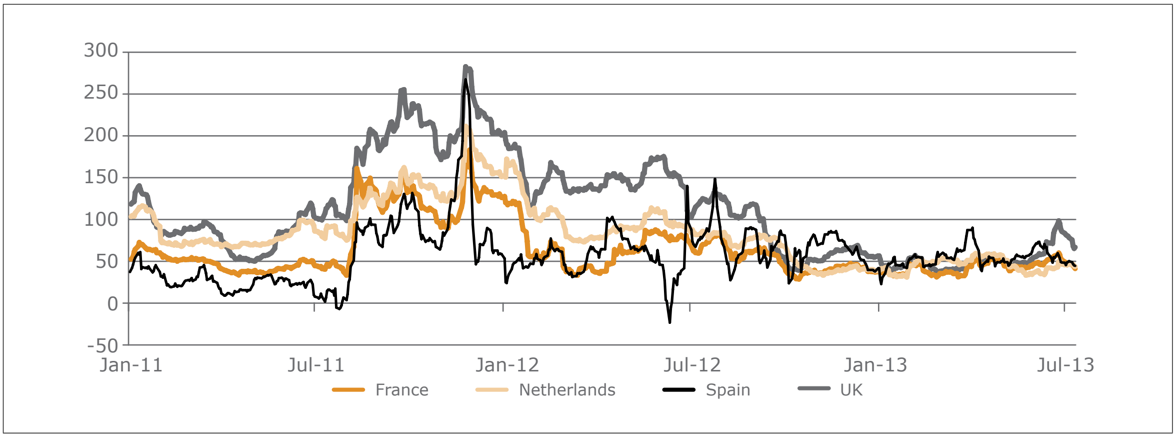
2.4.2 COVERED BONDS VS SENIOR UNSECURED BANK DEBT

By Frank Will and Jan King, RBS

Over the last few years, we have seen an increasing interest in covered bonds from traditional credit investors. Many of them preferred senior unsecured bank debt in the past due to the attractive yield pick-up offered by that asset class. In the second half of 2011, spreads of senior unsecured paper vs equivalent covered bonds widened considerably. In a 'risk-off' market environment, senior unsecured spreads tend to suffer more than covered bond spreads of the same issuer.

However, the two long-term LTROs by the ECB and the EU decision not to implement bail-in legislation until 2018 as well as the creation of the OMT gradually soothed market sentiments. Compared to late 2011, senior unsecured spreads are trading much closer to senior unsecured spreads again. At the time of writing (July 2013), swap spread differentials are hovering around the 50bp mark on average. That said, the differential can vary considerably for individual issuers depending on the respective perceived individual default risk differential between both asset classes of a particular bank and the differential in expected recoveries.

> Figure 1: 5Y Senior Unsecured minus Covered Bond Spreads in Selected Countries



Sources: RBS

Correlation analysis shows that the swap spread performance of both asset classes is highly correlated with the respective 5-year sovereign CDS spreads (with positive correlation coefficients of 0.8 to 0.9 for both covered bonds and unsecured bank debt). Covered bond investors are typically more risk averse than unsecured bank debt investors, and this is reflected in current spread levels.

PROS & CONS OF COVERED BONDS VS. SENIOR UNSECURED

As shown above, the gap between senior unsecured debt and covered bonds has narrowed significantly over the last couple of years. There were instances of covered bonds of a particular issuer trading wider than its unsecured debt in the respective maturity bucket in the past such as Washington Mutual in the months before the Lehman crisis in 2008. These cases were driven by a great level of distress and high uncertainty for issuers and highlighted the limited overlap of the investor bases of both products. However, we have not seen a market anomaly like this on a sustained basis. Senior unsecured spreads tend to move quicker than covered bond spreads, which might lead to temporary over-shootings of the differential. However, such dislocations would be exploited quickly unless they are attributable to a squeeze in one of the underlying bonds.

On the following pages we summarise the pros and cons for switching from senior unsecured debt into covered bonds. As highlighted in the table, both asset classes have a number of benefits and strengths. The key reasons for investing in senior unsecured bank debt are the usually higher yield offered by this asset class compared to covered bonds and the seniority of the claim versus the subordinated hybrid capital and equity. The main advantages of covered bonds are firstly the double recourse to the issuer and - in case of issuer insolvency - to the cover pool, secondly the higher rating (even though the number of issuers with AAA rated covered bonds is shrinking, the extent of the downgrades has not been as severe as in the case of the issuer ratings) and thirdly the favourable regulatory treatment for both, bank treasuries and insurance companies and in case of a bail-in of bank debt. These aspects are discussed in more detail below.

> Figure 2: Pros & Cons of Covered Bonds vs. Senior Unsecured

Advantages of Covered Bonds	Advantages of Senior Unsecured Debt
> double recourse to issuer and cover pool > higher rating than unsecured debt > lower risk weighting for EAA Covered Bonds bought by EEA banks > favourable treatment under Solvency II > generally better liquidity through larger issue size > favourable repo treatment at ECB and other central banks > highly rated covered bonds are eligible as liquid assets under Basel III rules > no risk of bailing-in of the secured claim	> higher yield (although 'spread give up' is currently at low levels) > less benchmark supply at the moment (but plenty of non-benchmark issuance) > often high turnover despite smaller deal sizes (due to lower portion of buy-and-hold investors)

HIGHER RATING STABILITY OF COVERED BONDS

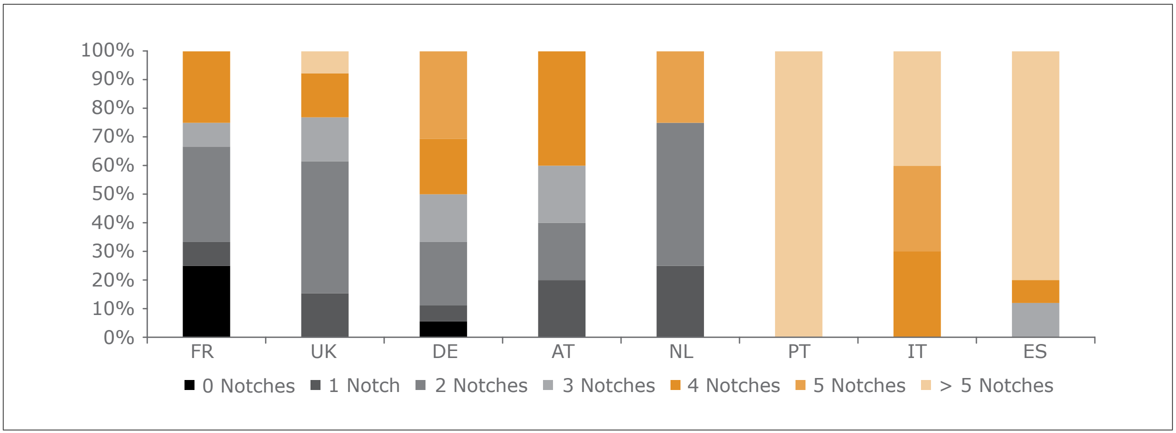
Covered Bond ratings depend on a number of factors of which the issuer rating is one as it forms the floor for the covered bond rating and limits its upside due to a linkage to the issuer rating (or the senior unsecured rating) within the rating methodologies of the major rating agencies. Since 2009, ratings of covered bonds have been negatively affected by issuer downgrades across all countries. Moreover, in some cases, Covered Bond ratings are capped due to low sovereign ratings (mainly in peripheral Europe). Our findings below are based on Moody's data from January 2009 to June 2013, and compare the migration of senior unsecured and Covered Bond ratings.

Impact on Senior Unsecured

Unsurprisingly, core European banks' ratings have been more resilient to the crisis than banks in the periphery, which is partly due to the fact that these banks still benefit from multiple notches of systemic support (although this will be diminishing over time upon upcoming regulations and decreasing willingness of governments to support banks) while the latter have been dragged down by rating downgrades of their respective sovereigns.

Among peripheral Covered Bond issuers, the impact on issuer ratings has been drastic (mainly in case of Portugal and Spain but also Italy). For instance, over 80% of Spanish covered bond issuers have been downgraded by more than 5 notches due to a combination of a weak sovereign (rated 9 notches lower in 2013 than in 2009) and deteriorating asset quality. The figure below shows the impact on LT ratings since 2009.

> Figure 3: Rating Migration of Issuers since 2009 (by country)

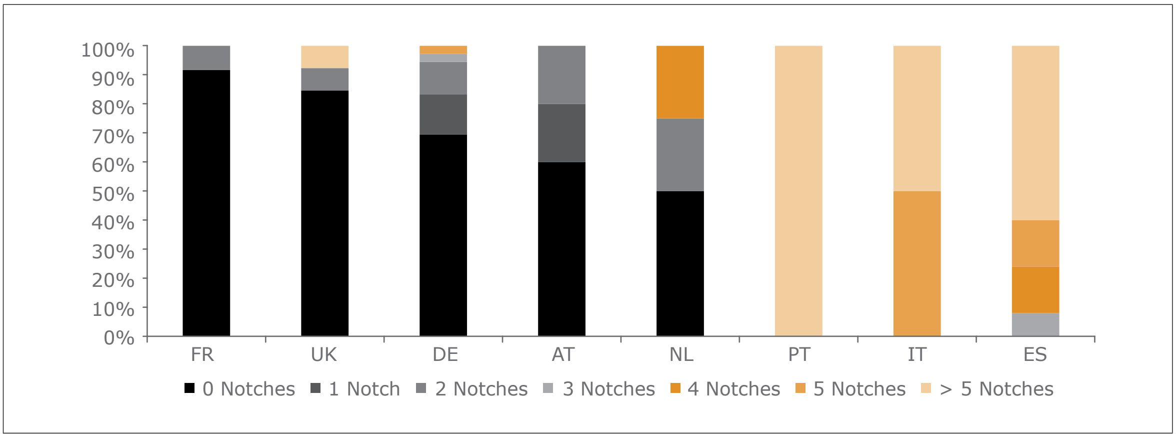


Sources: Moody's, RBS

Impact on Covered Bonds

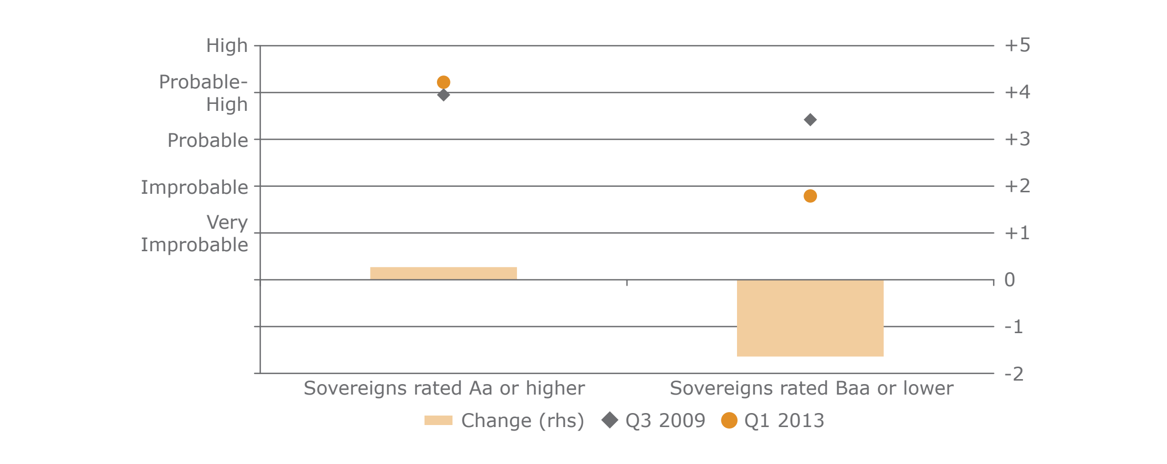
In contrast to senior unsecured, Covered Bond ratings have in general been more resilient thanks to their additional layers of protection. However, a clear distinction between the core and the periphery is evident in the chart below. The relative resilience against issuer downgrades is higher for issuers in highly rated countries where issuers benefit from unused notches of rating uplift. This is due to the fact that the linkage between covered bond and senior unsecured rating tends to increase (i.e. the TPI is lowered) if the credit quality of a country (and of the collateral located there) deteriorates as the likelihood of systemic risk issues increases.

> Figure 4: Rating Migration of Covered Bonds from 2009 to June 2013 (by country)



Sources: Moody's, RBS

> FIGURE 5: TPI CHANGES BETWEEN Q3 2009 AND Q1 2013 IN HIGHER VS LOWER RATED SOVEREIGNS



Sources: Moody's, RBS

ECB REPO HAIRCUTS

As part of its open market operations, the European Central Bank (ECB) has implemented risk-control measures to protect itself from potential collateral losses in case the underlying assets must be liquidated due to the counterparty's default. These measures encompass initial margins, valuation haircuts, variation margins, limits, additional guarantees and exclusions. The value of the underlying asset is calculated as the market value of the asset less a certain percentage ("valuation haircut"). The ECB applies different valuation haircuts for covered bonds and senior unsecured debt.

Within the ECB's haircut schedule, UCITS-compliant Jumbo covered bonds are generally in Category II. Non-Jumbo covered bonds, general law-based/structured covered bonds, and multi-issuer covered bonds such AyT Cédulas and Cédulas TdA are classified as category III bonds whereas senior unsecured bank bonds fall under Category IV. For further detail, please see Chapter 2.3 on the repo treatment of covered bonds by central banks.

In July 2013, the ECB amended its haircut schedule. For bonds rated in the AAA to A- category, the new haircut scheme further increased the gap between senior unsecured debt and covered bonds making the latter even more attractive for bank treasury investors. The haircut differential between a 4-year Jumbo covered bond and a 4-year senior unsecured bank bond increased to 8.5 percentage points and is even 9 percentage points in case of maturities beyond ten years. In the BBB-segment, the haircuts of senior unsecured bonds slightly improved vs covered bonds (mostly vs Jumbo covered bonds). Fixed-coupon BBB-rated 6-year Jumbo covered bonds would be subject to a 16% haircut, whilst similar senior unsecured bank debt would have a significantly higher haircut of 36%. BBB-rated Non-Jumbo covered bonds, general law-based/structured covered bonds, multi-issuer covered bonds such AyT Cédulas and Cédulas TdA are classified as category III bonds and would be subject to a 26% haircut for maturities within the 5-7 year bracket – still 10% below that of an unsecured bond.

OTHER CENTRAL BANKS ALSO FAVOUR COVERED BONDS

Other central banks' repo policies such as those of Danmarks Nationalbank, Norges Bank, the Reserve Bank of New Zealand, and the Reserve Bank of Australia also favour covered bonds. In Norway, senior unsecured debt is no longer eligible as collateral for repos, whilst covered bonds will continue to be eligible. Under Bank of England's narrow repo rules only government debt is eligible; neither covered bonds nor senior unsecured debt qualify. However, under its wider definition of Open Market Operations (OMO) collateral, covered bonds are eligible whilst senior unsecured debt does not qualify.

BASEL III'S LIQUID ASSET BUFFER RULES

In December 2009, the Basel Committee on Banking Supervision published a consultation paper defining minimum short-term and long-term liquidity levels for banks by introducing a liquidity coverage ratio (LCR) and a net stable funding ratio. The liquidity coverage ratio requires banks to hold a stock of unencumbered high quality liquid assets to meet 30 days cash outflows under an acute stress scenario. Meanwhile the net stable funding ratio (NSFR) measures the amount of longer-term, stable sources of funding employed by a bank relative to the liquidity profiles of the assets and the potential for contingent calls on funding liquidity arising from off-balance sheet commitments and obligations.

In January 2013, the Basel Committee announced the latest amendments of the LCR rules. The LCR will be introduced as planned on 1 January 2015, but the minimum requirement will start with 60%, rising in equal annual 10% steps to reach 100% on 1 January 2019.

The CRD IV/CRR implementing Basel III within the EEA has been finally approved by the European Parliament and will come into force on 1 January 2014. The CRD IV/CRR proposed a phasing-in regime similar to the Basel proposal, starting at 60% in 2015 but reaching 100% already in 2018. As opposed to covered bonds, senior unsecured bank debt will not qualify as liquid buffer assets. The final set of covered bonds that are eligible will depend on the EBA's liquidity analysis. The liquidity coverage rules should make covered bonds more attractive from an issuer perspective as this asset class benefits from higher investor demand than senior unsecured.

SOLVENCY II

Solvency II is the new capital adequacy regime for the European insurance industry. As a first step, the Solvency II Directive was adopted in 2009. However, the full regime has yet to be finalised. The Omnibus II Directive, currently being negotiated by the EU Parliament and Council, will set the date of entry into force of the Solvency II regime as well as the scope of the technical standards to be drafted by EIOPA.

The aim of the new solvency regime is to ensure the financial soundness of insurance undertakings, and in particular to enable them to withstand turbulent periods, to protect policyholders and the stability of the financial system as a whole. Solvency rules stipulate the minimum amounts of financial resources that insurers and reinsurers must have in order to cover the risks to which they are exposed.

Solvency II will introduce economic risk-based solvency requirements across all EU Member States for the first time. These new solvency requirements will be more risk-sensitive and more sophisticated than in the past, thus enabling a better coverage of the real risks run by any particular insurer. The new requirements move away from a crude "one-model-fits-all" way of estimating capital requirements to more entity-specific requirements. Solvency requirements will also be more comprehensive than in the past. Whereas at the moment the EU solvency requirements concentrate mainly on the liability side (i.e. insurance risks), Solvency II takes into account the asset-side risks as well.

In particular, insurers will now be required to hold capital against market risk (i.e. fall in the value of insurers' investments), credit risk (e.g. when third parties cannot repay their debts) and operational risk (e.g. risk of systems breaking down or malpractice). These are all risks that are currently not covered by the EU regime. However, experience showed that all these risk types can pose material threats to insurers' solvency.

The new framework – like the current rules – applies to almost all EU insurers and reinsurers. Only the smallest ones (which fulfil a number of conditions, including having gross written premium income of less than €5 million annually) will not be subject to these new rules, although they can choose to 'opt in'. Solvency II does not apply to pension funds covered by Directive 2003/41/EEC (the "occupational pension funds" Directive, or IORPs). The Commission is currently examining if suitable solvency requirements should be developed for pension funds.

The Solvency Capital Requirement (SCR) should ensure that the market value of assets will fall below the present value of liabilities only once in 200 years (99.5% 1-year VaR). The basic idea behind the standard formula for the SCR is that capital should be enough to absorb the total underperformance of assets compared to liabilities if a number of extreme market events happen simultaneously. Market risks are considered separately and then summed, with some benefit given to asset diversification.

Covered bonds are treated the same as other fixed-income investments in the market risk module except for the spread risk and concentration risk subcategories where they benefit from a favourable treatment compared to corporate and senior unsecured bank debt.

BAIL-IN RISK

An increasing number of investors are concerned about the bail-in risk of senior unsecured bank debt. A number of supervisory authorities including the Basel Committee on Banking Supervision, the European Commission as well as the regulators in Germany, the UK and Denmark have introduced resolution frameworks or have released consultation papers or draft directives on that topic.

a) Basel

One of the first papers that addressed the bail-in of senior unsecured bank debt was the Basel Committee paper on the loss absorbency of regulatory capital at the point of non-viability released in August 2010. It stated in the last paragraph of its appendix that "parallel efforts are ongoing to ensure that all banks that fail are capable of being effectively resolved and losses allocated to both senior and subordinated instruments." In its consultation paper, the Basel Committee argues that during the recent global financial crisis a number of distressed banks were rescued by their respective governments through common equity and other forms of tier-1 capital injections. This supported not only depositors but also investors in regulatory capital instruments and senior unsecured debt. Consequently, senior and subordinated debt did not absorb losses incurred by those banks that would have failed without the public sector support. The Basel Committee believes that public sector injections of capital "should not protect investors in regulatory capital instruments from absorbing the loss that they would have incurred had the public sector not chosen to rescue the bank".

b) EU

In January 2011, the European Commission published a consultation paper on how to deal with future bank failures in the EU and on how to minimise the risks of contagion, protect retail depositors and avoid costly bailouts by the taxpayer. The proposal took some guidance from the German restructuring law by including the extension of the powers of the regulators such as making changes to the business organisation and structure of banks, transferring assets and liabilities to another (bridge) bank, and writing down debt (and/or its conversion to equity) of a failing bank. At the end of March 2012, the European Commission published a new discussion paper on this new debt write-down tool and bail-in proposal. This document provided a more accurate view of the future tool to be implemented and stated that covered bonds would be exempted from the scope of this new tool.

In June 2013, the European Council published the latest proposal for a directive establishing a framework for the recovery and resolution of credit institution and investment firms. This proposal explicitly exempt covered bonds from write-down and conversion powers as they are regarded as "secured liabilities" (Art. 38, para 2 (b)). Our understanding is that the resolution authorities can bail-in the senior unsecured claim of a secured liability (i.e. should the cover pool not be big enough to cover all outstanding covered bonds, then the senior unsecured claim against the issuer for the portion of the original liability exceeding the cover pool assets can be subject to write-down / bail-in). However, the draft directive states that Member States may exempt UCITS 52(4) covered bonds from this provision. The latest proposal of the Recovery and Resolution Directive says that the bail-in tool should not apply until 1 January 2018.

STRUCTURAL SUBORDINATION

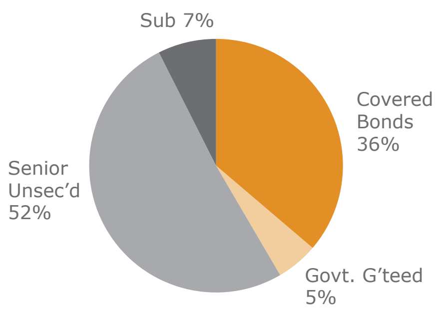
Another factor supporting the covered bond market is rising concerns from senior unsecured investors about structural subordination. The increased use of the covered bonds by banks over the last several years means that more and more assets are ring-fenced. As assets in the cover pool are not available to cover the claims of senior unsecured investors in case of issuer insolvency[1], investors have started to worry about the growth in covered bond issuance and the subsequent reduction of assets available to unsecured investors in an insolvency scenario. This problem is exacerbated by the rating agencies' demands for higher over-collateralisation levels, which in most cases significantly exceed the legal over-collateralisation requirements and further reduce the available assets for investors outside the cover pool.

While we understand the concerns in the market, we think the asset encumbrance discussions often tend to overstate the problem arising from structural subordination while ignoring offsetting factors. The use of covered bonds usually results in lower funding costs for the banks and significantly broadens the investor base allowing issuers to tap rates investors such as central banks. In addition, it is a more stable funding base. Even if the unsecured market is closed for an issuer, the bank may still be able to access the wholesale markets by the means of covered bonds or, in a worst case scenario, it can retain the bonds to use them for repo transactions with central banks such as the ECB.

In addition, the potential issue volume of covered bonds is not unlimited. The available eligible assets are a restricting factor for covered bond issuance putting a cap on the actual issue volumes. Also the aforementioned rating agencies' requirements of high over-collateralisation levels further reduce the available headroom for covered bond issuance.

The charts below show that senior unsecured funding still represents about half of European banks' funding. In the period of 2012 to H1 2013, based on Dealogic figures, covered bonds made up 36% of total issuance of European financial institutions (excluding securitisation and short-term funding) compared with 52% of senior unsecured funding and 7% of sub debt and government guaranteed funding. If retained covered bond and government guaranteed issuance is excluded, the portion of senior funding exceeds the 60% mark.

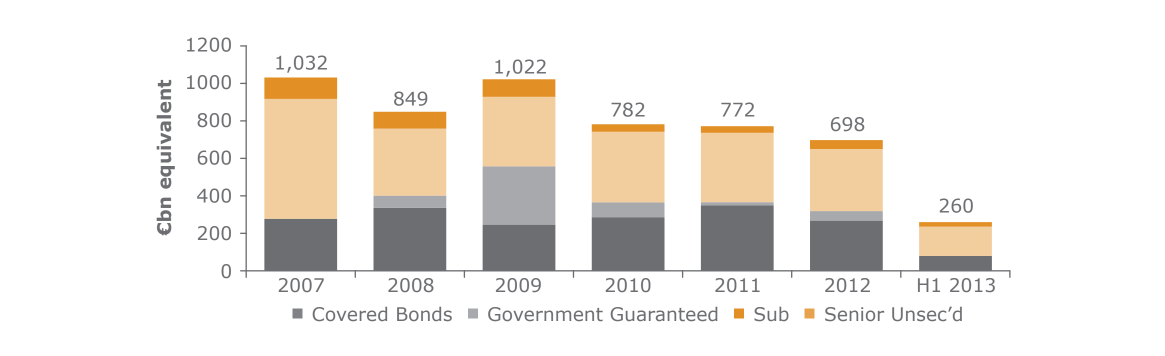
Figure 6: Issuance by European Banks In the period 2012 to H1 2013



Sources: Dealogic, RBS

1 If all the covered bonds of an insolvent issuer have been repaid and the claims of all covered bond investors have been satisfied, the remaining assets in the respective cover pool would generally be made available on a pro-rata basis to the senior unsecured investors. Moreover, in some jurisdictions, such as Germany, in case of issuer insolvency senior unsecured investors would have access to assets in the cover pool that are visibly not necessary to cover the outstanding covered bonds and related liabilities. Given the dynamic character of the market a very high hurdle must be overcome in order for this process to trigger, and we would expect that only in very few, selected cases the insolvency administrator of the cover pool would agree to such a transfer.

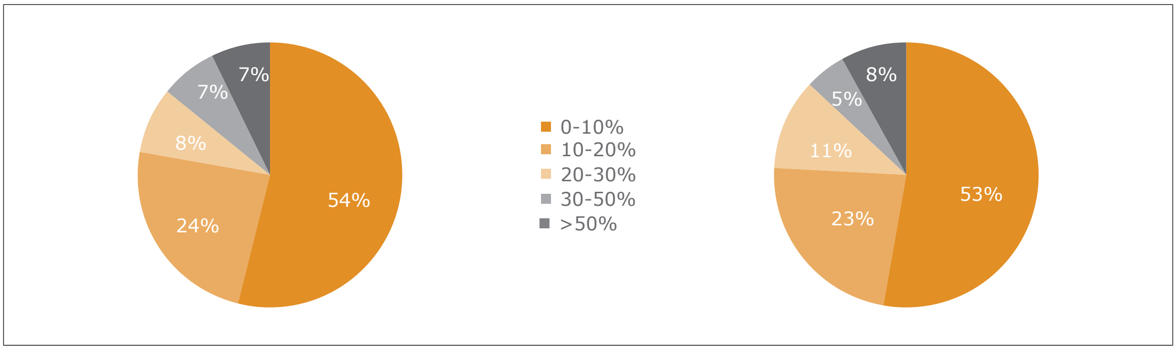
> FIGURE 7: ISSUANCE BY EUROPEAN BANKS SINCE 2007



Sources: Dealogic, RBS (excluding short-term debt and securitisation)

Fitch's covered bond study published in June 2013 showed that more than 50% of the covered bond issuers rated by Fitch have a funding reliance (defined as outstanding covered bonds in % of adjusted total assets) of less than 10%. Only about 1 in 4 issuers has a funding reliance of more than 20%. Many of these are specialised mortgage banks.

> FIGURE 8: COVERED BOND FUNDING RELIANCE OF ISSUERS (LEFT: 2011, RIGHT: 2012)



Sources: Fitch, RBS (by number of issuers rated by Fitch; funding reliance is defined as outstanding covered bonds in % of total assets)

INVESTOR DEMAND

We believe that one of the drivers of the spread tightening between unsecured and secured bank debt had been the limited overlap of senior unsecured and covered bonds investors. Analysing recent order books, we believe that the investor overlap is increasing due to the higher participation of credit investors in new covered bond issues. We expect this trend to continue over the coming years and credit investors will account for a growing portion of the covered bond order books going forward, not least because of the bail-in risk for European senior unsecured debt with maturity dates of 2018 and beyond.

The main reasons, in our view, for the limited overlap are (1) that central banks and sovereign wealth funds are large buyers of covered bonds but not of senior unsecured debt, (2) that asset managers and pension funds have often higher limits for covered bonds than for senior unsecured bank debt, and (3) that both assets classes are usually bought for different dedicated portfolios. In addition, covered bonds are sometimes used to enhance the yield of government portfolios without diluting the average rating or in genuine credit portfolios to improve the rating quality of the portfolio. Senior unsecured bonds are primarily bought by banks and assets managers and form part of the credit portfolio.

CONCLUSION

The spread differential between covered bonds and senior unsecured paper is highly issuer-specific. Senior unsecured spreads tend to be more volatile than covered bond spreads. Temporary overshoots of spreads can provide opportunities to switch into or out of covered bonds. The relatively tight spread between the two asset classes observed since late 2012 means that the spread give-up for investors would be relatively small in many cases and those investors switching into covered bonds would be more than compensated by the aforementioned advantages of this asset class in terms of higher rating and additional investor protection, in our view.

This holds particularly true for EU bank investors, who additionally benefit from the lower risk weighing under the European Capital Requirements Directive (CRD), the lower ECB repo haircuts and the prospect of covered bonds qualifying as liquid assets under the upcoming liquid buffer rules. Insurance companies would also benefit from investing into covered bonds as these instruments will receive a favourable treatment under the upcoming Solvency II rules. The structural subordination of senior unsecured investors as a result of increased covered bond issuance poses some problems, but the current discussion exaggerates the issue ignoring the advantages of having a stable and relatively cheap funding channel for the bank: this is beneficial for both covered bond and senior unsecured investors. Moreover, there is an increasing risk of a bail-in of senior unsecured debt whilst covered bonds are explicitly excluded from such measures in various countries including for instance Germany and Denmark as well as under the EU Recovery and Resolution Directive.

CHAPTER 3 - THE ISSUER'S PERSPECTIVE

3.1 AUSTRALIA

By Alex Sell, Australian Securitisation Forum

I.FRAMEWORK

The legal framework is principally a contractual one in nature, with a statutory overlay that makes certain provisions for the prudential regulator to make regulations in relation to issuers' covered bond programmes, as well as provisions for minimum overcollateralisation levels (103% at all times).

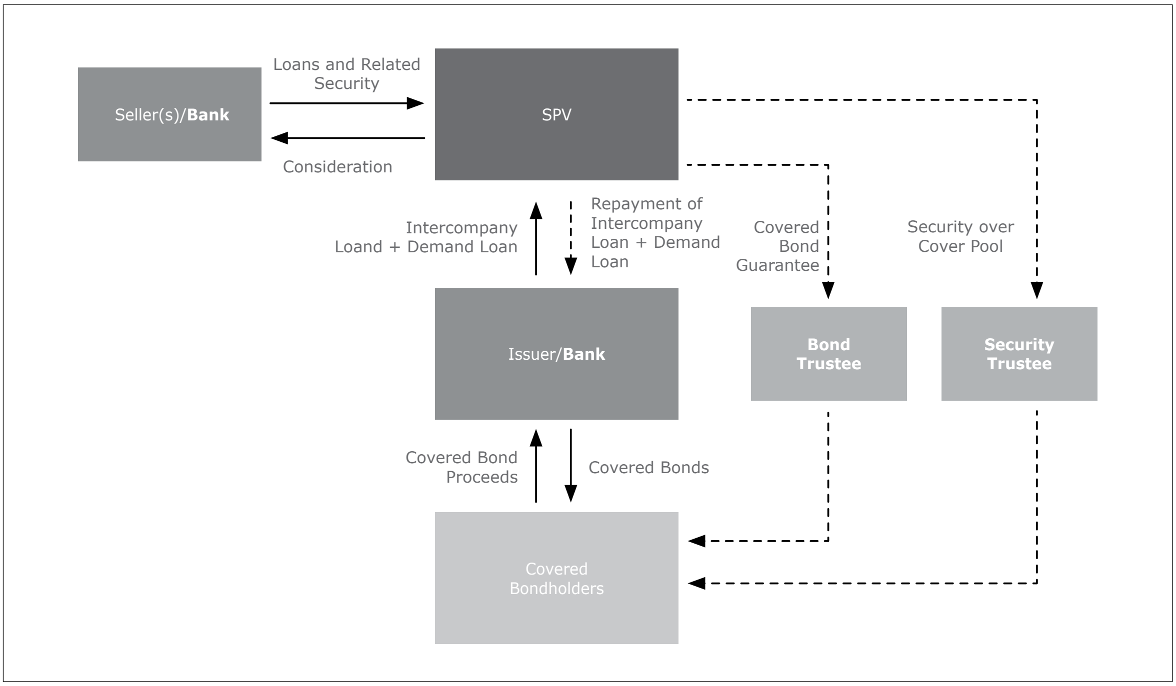
Prior to the introduction of amending legislation, the prevailing view among the regulatory community was that the Banking Act 1959 prohibited banks from placing any other class of creditors above depositors. The amendment to the Banking Act in November 2011 permitted this to occur, subject to an encumbrance limit of 8% (or such other percentage as may be prescribed by regulations) of an issuer's a*ssets in Australia*, as defined.

II. STRUCTURE OF THE ISSUER

Australian banks are the issuers of covered bonds; not SPVs or any other entity. However, the issuer makes an inter-company loan to the cover pool SPV to enable the SPV to acquire the cover pool and in turn provide a guarantee over the issuer's obligation to covered bond holders. This guarantee will be called upon in an issuer event of default. The cover pool permits the SPV to continue to make scheduled payments on the bonds following an issuer event of default. Bond holders' benefit from security granted by the SPV over the cover pool to secure the SPV's obligations, including in respect of the guarantee. At present, the cover pool assets may not exceed 8% of an issuer's *assets in Australia*. With the exception of the fixed 8% maximum, the Australian covered bond resembles the British and New Zealand models. The charge over the assets of the cover pool does not, however, remove any claim creditors may wish to also make on the estate of the bank issuer.

Under the Banking Act, the cover pool cannot exceed 8% of '*assets in Australia*'. An Authorised Deposit-taking Institution (ADI) must not issue a covered bond if the combined value of assets in cover pools securing covered bonds issued by the ADI would exceed this 8% but there may be voluntary overcollateralisation (e.g. in the form of a demand loan) that takes the total value of assets held by the SPV over 8%. The voluntary overcollateralisation may rank equally with covered bonds (thus forming part of the cover pool and subject to the 8% cap) or senior to the covered bonds (thus outside the 8% cap). In keeping with other jurisdictions the voluntary overcollateralisation serves as a management buffer in order to avoid inadvertent contractual breaches in respect of the Asset Coverage Test and to make ongoing covered bond issuance more efficient. Where the voluntary overcollateralisation ranks senior to the covered bonds (i.e. it is not part of the cover pool) such voluntary overcollateralisation remains part of the bank's estate and may be returned to the bank at any time. Further, whilst the bank can exceed the 8% maximum, it will attract a deduction from its regulatory capital base equal to the value that exceeds 8%.

Any amount recovered against the insolvency estate (and for which bondholders rank equally with all other senior unsecured creditors but behind depositors) will be paid over to the SPV to be held as additional collateral which is used to make payments under the guarantee. Any excess of assets in the SPV over and above the amount of the bonds issued – once repaid – will, after the satisfaction of other secured liabilities of the SPV, be paid to the insolvency estate of the issuer by way of repayment of the amount outstanding under any remaining intercompany loan amounts. However where voluntary overcollateralisation ranks senior to covered bond payments, the voluntary overcollateralisation will be returned to the issuer ahead of payments on the covered bonds.



III. COVER ASSETS

The Banking Act 1959 - Section 31[1] sets out the assets that can be included in the cover pool. These are:

a. an at call deposit held with an ADI and convertible into cash within 2 business days;

b. providing no greater than 15% of the total cover pool, a bank accepted bill or certificate of deposit that:

   1. matures within 100 days; and
   2. is eligible for repurchase transactions with the Reserve Bank; and
   3. was not issued by the ADI that issued the covered bonds secured by the assets in the cover pool;

c. a bond, note, debenture or other instrument issued or guaranteed by the Commonwealth, a State or a Territory;

d. a loan secured by a mortgage, charge or other security interest over residential property in Australia;

e. a loan secured by a mortgage, charge or other security interest over commercial property in Australia;

f. a mortgage insurance policy or other asset related to a loan covered by paragraph (d) or (e);

g. a contractual right relating to the holding or management of another asset in the cover pool;

h. a derivative held for one or more of the following purposes:

   1. to protect the value of another asset in the cover pool;
   2. to hedge risks in relation to another asset in the cover pool;
   3. to hedge risks in relation to liabilities secured by the assets in the cover pool.

1 http://www.austlii.edu.au/au/legis/cth/consol_act/ba195972/s31.html

At the time of publication, all Australian covered bond issuers limited themselves contractually to excluding any commercial mortgage collateral in their cover pools.

IV. VALUATION AND LTV CRITERIA

Contractually, cover pool assets are subject to revaluation every month by way of indexation, which varies between programmes. Please refer to each issuer's individual website for details of the index used and the methodology applied.

LTV criteria – in addition to indexation – are contained in Section 31A of the Banking Act. Specifically, they are as follows:

> Residential mortgages – if the mortgage exceeds 80% of the value of the property then the value of the loan is reduced by the amount of the excess.

> Commercial mortgages - if the mortgage exceeds 60% of the value of the property then the value of the loan is reduced by the amount of the excess.

V. ASSET - LIABILITY MANAGEMENT

This is principally a matter for the credit rating agencies in relation to timely payment and their opinions on the value of the pool in liquidation scenarios. The issuers have regard to ECAI's methodologies and criteria to seek to ensure maintenance of AAA ratings.

VI. TRANSPARENCY

Since August 2012, an Australian Transparency Template has been in force, followed by each of the five Australian covered bond issuers. It is in line with the guidelines of the ECBC's Covered Bond Label Initiative, and covers the following areas of each issuer's programme:

> Legend

> Parties

> Asset Coverage Tests Bond Issuance

> Prepayments

> Pool Summary

> Mortgage Pool

> Contact

> Disclaimer

> Terminology

> Ratings Compliance Tests

Please refer to the Australian Securitisation Forum's covered bonds landing page[2] to access the template in full as well as web links to individual issuer's programmes.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Prudential Standard APS 121 - Covered Bonds[3] contains the regulations set by the administrator (regulator) of the Banking Act in Australia.

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2 http://www.securitisation.com.au/cbprofile

3 http://www.apra.gov.au/adi/PrudentialFramework/Documents/120719-APS121-Covered-bonds-final2.pdf

The cover pool monitor is appointed by the bank issuer but must be independent and must provide reports in respect of the cover pool to the bank regulator on request. Specific tasks it must perform on and report biannually on are:

> No breach of the 103% statutory minimum overcollateralisation

> Assess compliance by the issuer with assets permitted to be in the cover pool under the Banking Act

> Confirm that the covered bond pool asset register is being maintained in line with regulation (APS121)

> Contractually, also obliged to check the arithmetic accuracy of asset coverage tests on an annual basis

The bank regulator has the power to instruct – publically or secretly – a bank to cease topping up its cover pool should it wish to invoke its broad powers under the Banking Act, such that it has broader concerns about the bank's prudential condition.

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

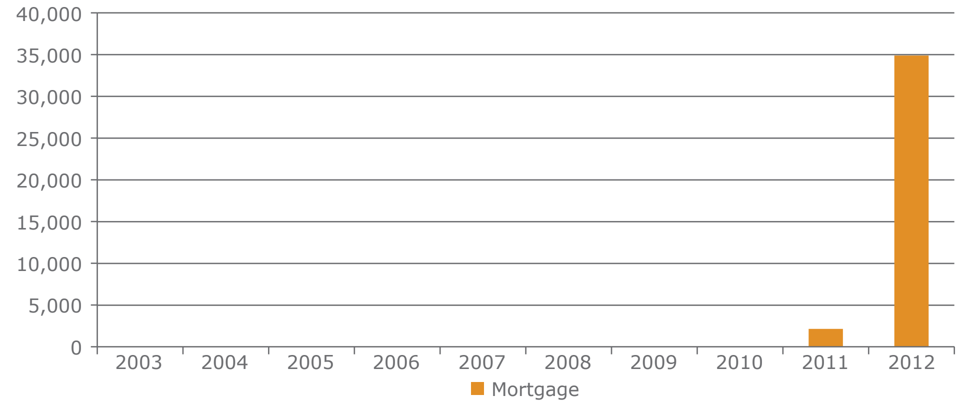
Cover pool assets are sold by the bank issuer to the SPV, backed by contract. The security charge held over the cover pool assets is recognised at law and shall not be jeopardised in the event of bankruptcy/insolvency of the issuer.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Not in compliance with UCITS because Australian issuers are not domiciled in member states of the EEA.

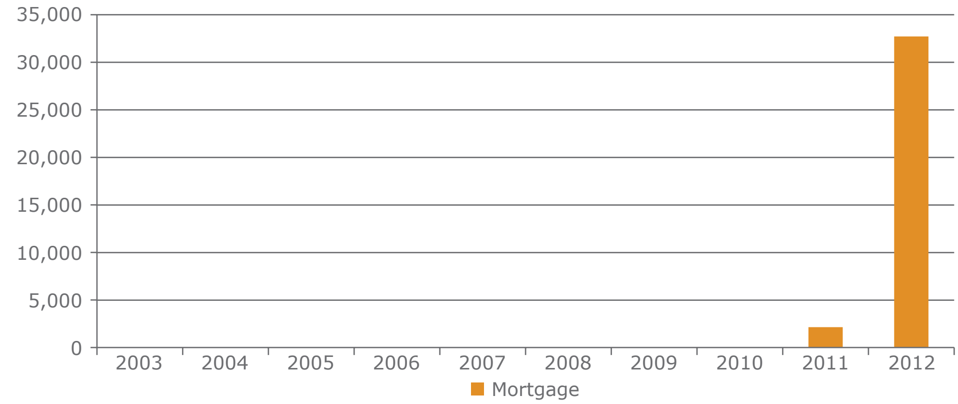
Risk weighting varies depending upon the jurisdiction concerned, pending standardised risk-weights from the EBA and the outcome of the current Basel consultation.

> Figure 1: Covered Bonds Outstanding 2003-2012, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2012, EUR m



Source: EMF/ECBC

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/98/Australian_Covered_Bonds

3.2 AUSTRIA

By Alexa Molnar-Mezei, Erste Group Bank
and Friedrich Jergitsch, Freshfields Bruckhaus Deringer

I. FRAMEWORK

Austria has three different frameworks under which covered bonds can be issued. These are:

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

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

Amendments of all three laws have been suggested by Austria's banks to the legislator with the aim of further harmonizing/unifying Austrian Pfandbrief legislation in a single Act, and including, for example, an improved risk management system and standardised reporting requirements to achieve more transparency that offer investors a high level of security in terms of frequency and scope of the reports and ensure that investors receive clearly defined data relating to the cover assets.

II. STRUCTURE OF THE ISSUER

All three laws provide that only duly authorized credit institutions, with a special license to such effect, may issue covered bonds.

The Mortgage Banking Act stipulates a specialist banking provision and this would apply to any new mortgage bank. However, the only 2 issuers under the Mortgage Banking Act currently are universal banks into which former specialised issuers were merged.

The Mortgage Bond Act applies to public-sector "Landes-Hypothekenbanken", which used to be owned by the Austrian provinces and some of which have been privatised.

The Law on Secured Bank Bonds applies to all banks who have a license allowing them to issue covered bonds.

Under all frameworks, the issuer holds the cover assets on its balance sheet (unless it uses another bank's assets as cover, which is permitted under pooling rules contained in all three laws) and the assets are not transferred to a separate legal entity. This means that the covered bonds are an unconditional obligation of the issuer, rather than a direct claim (solely) on the cover assets. In the case of insolvency of the issuer, the cover assets will form a pool which is separate from the issuer's other assets and a special cover pool administrator will be appointed to manage the cover assets. The covered bond holders have a preferential claim on the cover assets.

III. COVER ASSETS

Eligible cover pool assets are loans secured by (predominantly) first-ranking mortgages and public-sector assets. ABS/MBS are not eligible. Pfandbriefe backed by mortgage loans are commonly referred to as "Hypothekenpfandbriefe", while Pfandbriefe backed by public sector assets are referred to as "öffentliche Pfandbriefe".

The Law on Secured Bank Bonds allows mixed cover pools consisting of mortgage loans and public-sector assets but in practice, issuers under that law form separate pools with mortgages and public-sector assets, too, each backing a separate class of covered bonds.

The geographical scope of eligible mortgage assets is restricted to EU / EEA countries and Switzerland. USA, Canada and Japan are not eligible. For eligible countries that do not recognise the bondholders' insolvency privilege, a 10% limit is in place. For "öffentliche Pfandbriefe", the geographic scope of assets is the same.

The limits for FBS are similar. In addition to mortgage loans and public-sector assets, FBS may also be backed by assets which, by law, are suitable for investment of a ward's assets ("Mündelgelder"). This includes certain local public bonds, or Austrian Pfandbriefe.

Derivative contracts are allowed in the cover pool if they are entered to hedge interest rate, currency and credit default risks. Derivatives are only allowed for hedging and there is no limit in place on the volume of derivatives in the cover pool.

So-called substitute cover assets are limited to 15% of the amount of covered bonds outstanding and may consist of cash, bank deposits and bonds from public issuers from EEA countries and Switzerland.

IV. VALUATION AND LTV CRITERIA

The Mortgage Bank Act stipulates conditions for property valuation and the value of mortgage lending. One condition is a 60% LTV (loan to value) limit for residential and commercial mortgages based on the so-called "mortgage lending value" (which is a conservatively assessed value).

For Mortgage Bond Act issuers, the 60% LTV limit is stipulated in the statutes of each issuer for historical reasons.

There is no explicit provision for property valuation for FBS but – to our knowledge – issuers mostly adhere to the 60% LTV limit stipulated in the Mortgage Bank Act.

In practice, monitoring of the property value is done by the issuer and regular audits of the cover register are undertaken. Valuation guidelines mostly follow the guidelines prepared by each issuer for solvency purposes, which are approved by the regulator.

V. ASSET - LIABILITY MANAGEMENT

All Austrian Covered Bond laws contain the matching principle whereby the total volume of assets in the cover pool must at least cover the total nominal amount of outstanding covered bonds, the interest payable on the outstanding covered bonds and potential running costs in case of insolvency of the issuer (expressed under the Mortgage Bank Act and Mortgage Bond Act as mandatory overcollateralization of 2% which must be held in highly liquid substitute cover assets).

In addition, issuers may opt in their statutes to maintain cover on a net present value basis, which is used by many of the international benchmark issuers. Issuers may also provide additional over-collateral at their discretion, for instance in order to meet rating requirements and withstand stress tests.

The legislation also contains a simple maturity matching formula, limiting the issuance of bonds the maturity of which is considerably greater than the maturity of assets in the cover pool.

VI. TRANSPARENCY

The Austrian issuers organised in the Austrian Covered Bond Forum have set up a working group developing and analysing the CBIC Template guidelines. As a result, Austrian issuers have developed a National Transparency Template –available on the Covered Bond Forum and of the Covered Bond Label websites – with quarterly updates – based on the CBIC European Transparency Standards. The cover pool reports can be found at:

One central website of Austrian Covered Bond Forum: http://www.pfandbriefforum.at/downloads.html

The National Transparency Template includes the following information:

> Program and Issuer Senior and Covered Bond ratings;
> Overcollateralization values (based on nominal and net present values);
> The total volume of Pfandbrief outstanding as well as the related cover pools in terms of nominal, net present and stressed net present value;
> The share of further cover assets;
> The maturity structure of the Pfandbrief and cover assets;
> Information on the size of the cover assets;
> Information on the mortgages by property type/type of use, region and state;
> Information on the claims against the public sector by state and type of issuer;
> Information on the mortgages registered liens by register country;
> Summary tables including LTV, currency, interest and maturity profile

Furthermore, the members of the CB Forum aim to develop and expand the existing template with the General Issuer Details and Key Concept Explanations Sections based on the CBIC transparency template.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The cover pool is monitored by a trustee ("Treuhänder" or, in the case of the Law on Secured Bank Bonds, "Regierungskomissär"), who is appointed by the Minister of Finance. The trustee is liable according to the Austrian civil code. The trustee has to ensure that the prescribed cover for the covered bonds exists at all times and that the cover assets are recorded correctly in the cover register. Without his or her approval, no assets may be removed from the cover pool. Any disputes between the issuer and the trustee would be settled by the regulator.

If a concern exists that the rights of the covered bond holders are being infringed, the court must appoint a joint special representative of the covered bond creditors ("Kurator").

VIII. SEGREGATION OF COVER ASSES AND BANKRUPTCY REMOTENESS OF COVERED BONDS

The cover register ("Deckungsregister") in which all cover assets are entered, permits the identification of the cover assets. All mortgages, public-sector loans, substitute cover assets and derivative contracts which form part of to the cover, must be registered in the cover register.

The issuers must inform the debtors (or, as the case may be, counterparties) of the cover assets that their debt (or derivative contract) is made part of the cover pool. On that occasion the issuer must also notify the debtor that it is not allowed to discharge its debt through any set-off. An exemption from the general prohibition of set-off applies to derivative contracts, when the set-off (or netting) occurs in respect of receivables arising under one and the same Master Agreement.

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

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

Asset segregation

Cover assets may only be enforced upon by the covered bond creditors (or counterparties of derivative contracts which form part of the cover pool).

If the issuer becomes insolvent, the cover assets are segregated from the remainder of its assets. The cover assets form what is known as 'Sondervermögen' (pool of special assets) and are earmarked for the claims of the covered bond holders. Any voluntary overcollateralization is also bankruptcy-remote. Only cover assets that are evidently not needed to satisfy the claims of the covered bond holders are passed back to the issuer's general insolvency estate.

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

Impact of insolvency proceedings on covered bonds and derivatives

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

Preferential treatment of covered bond holders

Covered bond holders enjoy preferential treatment as the law stipulates the separation of the cover assets on the one hand and the insolvency estate on the other hand. To the extent that they are not satisfied from the cover assets, the covered bond holders may also participate in the issuer's general insolvency proceedings. Only if the cover assets do not suffice to satisfy the covered bond creditors, are the covered bonds accelerated.

Access to liquidity in case of insolvency

Once appointed, the special administrator for the cover pool has the duty to manage the cover pool in order to satisfy the claims of the covered bond holders. The administrator may, for example, sell assets in the cover pool or enter into a bridge loan in order to create liquidity to service the bonds in issue.

The administrator also has access to any voluntary over-collateralisation, which is considered bankruptcy-remote. Any surplus collateral may only be transferred back to the insolvency estate to the extent that it is evident that it will not be needed to cover the claims of the covered bond holders.

Sale and transfer of mortgage assets to other issuers

By virtue of his or her appointment, the special administrator has the right to manage and dispose of the cover assets. In particular, the special administrator must collect the cover assets according to their contractual maturity.

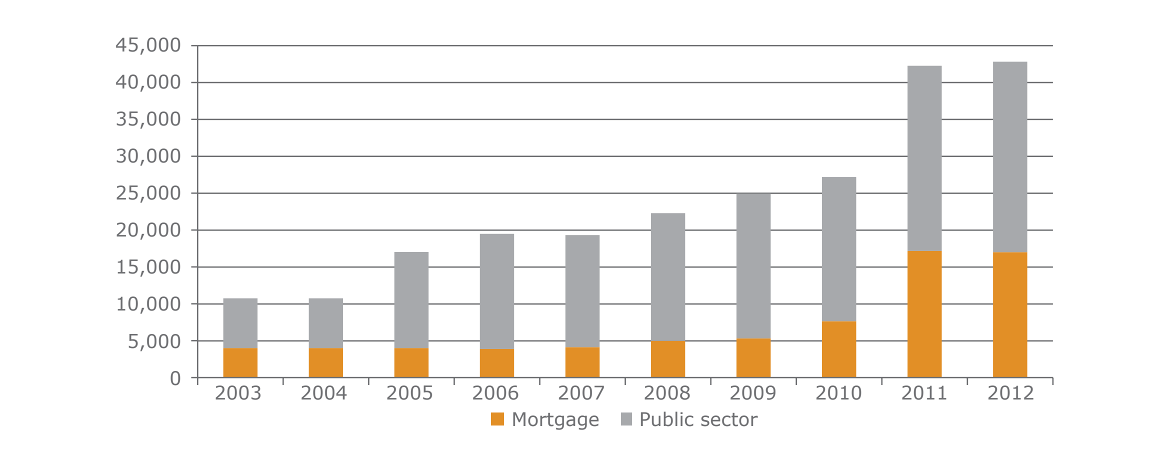
The special administrator is also entitled to sell the assets collectively to a separate credit institution. This institution must then take over all liabilities with regard to the covered bonds. In fact, one of the tasks of the special administrator is to find a suitable credit institution that will buy the assets collectively. If a sale is not feasible, the cover pool administrator has to continue the servicing of the cover pool and the outstanding covered bonds.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Austrian Pfandbriefe, as well as Austrian Covered Bonds (FBS), fulfil the criteria of the UCITS 52(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.

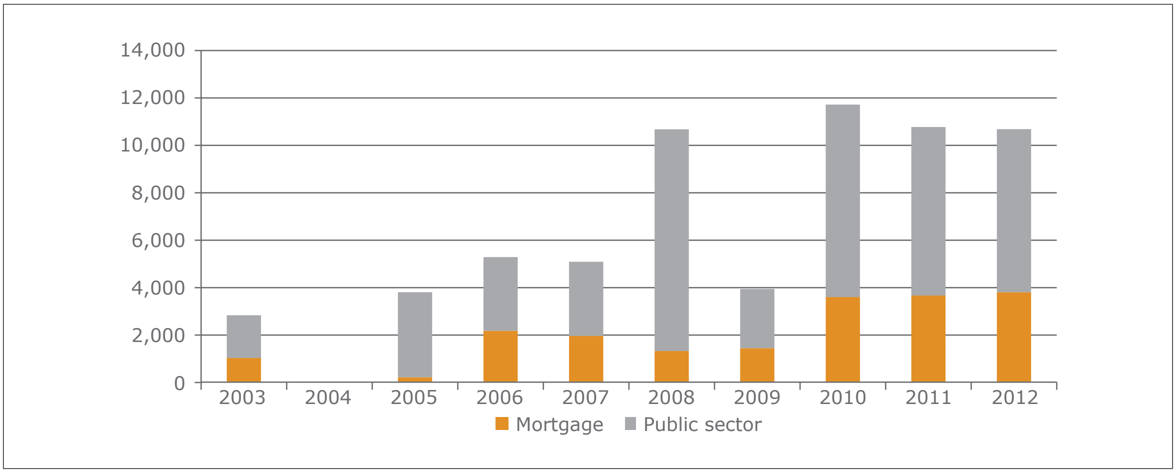
Austrian Covered Bonds are eligible in repo transactions with the national central bank.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2012, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2012, EUR M



Source: EMF/ECBC

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/8/Pfandbriefe and http://ecbc.eu/framework/95/FBS_-_Fundierte_Bankschuldverschreibungen

3.3 BELGIUM

By Carol Wandels, Belfius Bank

I. FRAMEWORK

On 3 August 2012, the Belgian Parliament adopted the long-awaited legislation on covered bonds. This law provides a statutory framework for the issuance of covered bonds by Belgian credit institutions.

The legal basis for Belgian covered bonds is incorporated into the Act of 22 March 1993 on the status and the supervision of credit institutions. Since 18 October 2013 this law is supplemented by two Royal Decrees (a general Royal Decree on the issuance of covered bonds and a specific Royal Decree dedicated to the cover pool administrator) and several regulations (inter alia concerning the issuer reporting requirements).

The following gives an overview of the legislative framework for Belgian covered bonds:

> The Law of 3 August 2012 establishing a legal regime for Belgian covered bonds, which was implemented through an amendment of the Law of 22 March 1993 on the status and supervision of credit institutions (the "**Covered Bond Law**");

> The Law of 3 August 2012 on various measures to facilitate the mobilisation of claims in the financial sector (the "**Mobilisation Law**");

> The Royal Decree of 11 October 2012 on the issuance of Belgian covered bonds by Belgian credit institutions (the "**Covered Bond Royal Decree**").

> The Royal Decree of 11 October 2012 on the cover pool administrator in the context of the issuance of Belgian covered bonds by a Belgian credit institution (the "**Cover Pool Administrator Royal Decree**");

> The Regulation of the National Bank of Belgium concerning the practical modalities for the application of the Law of 3 August 2012 that establishes a legal regime for Belgian covered bonds dated 29 October 2012 (the "**NBB Covered Bonds Regulation**"); and

> The Regulation of the National Bank of Belgium addressed to the statutory auditors and the cover pool monitors of Belgian credit institutions with respect to their involvement in the context of the issuance of Belgian covered bonds in accordance with Chapter VIII of the Law of 22 March 1993 dated 29 October 2012 (the "**NBB Cover Pool Monitor Regulation**").

II. STRUCTURE OF THE ISSUER

Belgian covered bonds can be issued by universal credit institutions[1] established in Belgium. However such institutions will first need to be licensed by the NBB as covered bond issuer (general authorisation as issuer) and also the covered bond program (specific program license) itself will need to get approval from the NBB.

An extensive issuer license file detailing aspects like its strategy, solvency, risk management, asset encumbrance, IT systems, internal audit, etc. needs to be submitted.

At program level the issuer will need to detail the impact of the covered bond issuance on its overall liquidity, the quality of the cover assets and maturity matching of assets/liabilities in the program. The statutory auditor of the issuer will need to report to the NBB on the organizational capacity of the credit institution to issue and follow up the covered bonds.

1 Existing credit institutions could decide to issue themselves or to issue from a newly created credit institution. The latter would typically, but not necessarily, be a subsidiary or an affiliate of the mother company.

If all three files have been submitted to the NBB, a license can be obtained but it might be conditional upon respecting issuance limits that the NBB on a case-by-case basis might decide on. If licensed, the issuer and the program(s) will be added to specific lists that will be available for consultation on NBB's website.

An indirect issuance limit on covered bonds has been integrated in the Covered Bond Royal Decree by limiting the amount of cover assets to 8% of the balance sheet.

At program level a distinction is made between CRD-compliant covered bonds, i.e. "Belgian pandbrieven/lettres de gage", and non CRD-compliant (but still UCITS compliant) covered bonds, i.e. "Belgian covered bonds". The denomination of both terms is protected by law. These distinct types of covered bonds will appear on two separate lists. Consultation of the NBB's website will hence give an overview of:

> Belgian credit institutions issuing covered bonds

> Belgian pandbrieven programs and its specific issuances

However, the way that the law and the Royal Decree are stipulated makes that in practice the Belgian credit institutions will only be able to issue CRD-compliant covered bonds. Therefore, in what follows we will only concentrate on the Belgian pandbrieven.

When a credit institution issues Belgian pandbrieven, its assets will by operation of law consist of two distinct estates: its general estate on the one hand and a separate, ringfenced "segregated estate" ("patrimoine special") on the other hand (=balance sheet structure, no use of a special purpose vehicle). The general estate will comprise those assets of the issuing bank to which all its creditors have a direct recourse.

The Belgian pandbrieven investors will have a direct recourse to (i) the general estate of the issuing credit institution (i.e. repayment of the Belgian pandbrieven is an obligation of the issuing bank as a whole) and (ii) the segregated estate, that will comprise the cover pool that is exclusively reserved for the Belgian pandbrieven investors of a specific program and for the claims of other parties that are or can be identified in the issue conditions. Assets will become part of the cover pool upon registration in a register held by the issuer for that purpose. As of that moment those assets will form part of the segregated estate and are excluded from bankruptcy clawback risk.

When insolvency proceedings are opened, by operation of law, the assets recorded in the segregated legal estate do not form part of the insolvent general estate and hence will not be affected by the opening of the insolvency proceedings. Belgian pandbrieven investors will upon insolvency of the credit institution fall back on the cover pool assets for the timely payment of their bonds but, at the same time, holders will continue to have a claim against the insolvent general estate. Creditors that are not related to the segregated estate will not have any recourse to these cover pool assets. Any amounts left in the special estate can return to the insolvent general estate, upon the request of the bankruptcy receiver and after consultation of the NBB, once it is certain that the cover assets are no longer needed.

III. COVER ASSETS

All assets and instruments that will be legally segregated for the benefit of the Belgian pandbrieven investor in a separate estate constitute the cover pool. The cover pool can be composed of assets that are part of any of the following categories:

> Category 1: residential mortgage loans, and/or senior RMBS

> Category 2: commercial mortgage loans, and/or senior CMBS

> Category 3: exposure to the public sector, and/or senior public sector ABS

> Category 4: risk on financial institutions

> Category 5: derivatives

These five general categories are subject to further eligibility criteria:

- Geographical scope: OECD, except for category 1 and 2 that are further restricted to EEA; for category 3 non-EU public sector exposure will get a zero valuation, unless specified otherwise.
- With respect to the MBS/ABS as mentioned in each of the first three categories: senior ABS/MBS are eligible provided that 90% of the underlying pool is directly eligible and is originated by a group related entity of the issuer of the Belgian pandbrieven. The senior ABS/MBS must qualify for credit quality step 1 (as set out in annex IX, part 4, 6 of the 2006/48/CE Directive). The securitization vehicle of the ABS/MBS must be located in the EU. At last these securitization tranches only remain eligible as cover asset within the limits imposed by the 2006/48/CE Directive;
- For the mortgage loans mentioned in category 1 and 2: the loans need to be guaranteed by first lien (and subsequent lower ranking) mortgages on (residential or commercial) properties located in the EEA. Mortgage loans with properties under construction/in development can only be added to the cover pool if they do not represent more than 15% of all the mortgage loans taken up in the cover pool; Residential real estate is defined as real estate property that is destined for housing or for leasing as housing by the owner. Commercial real estate is real estate property that is primarily used for industrial or commercial purposes or for other professional activities such as offices or other premises intended for the exercise of a commercial or services acitivity;
- For category 3: exposure to the public sector can only be (i) exposure to or guaranteed or insured by central governments, central banks, public sector entities, regional governments and local authorities or (ii) exposure to or guaranteed or insured by multilateral development banks or international organizations that qualify as a minimum for a 0% risk weighting as set out in annex VI, 20 of the 2006/48/CE Directive;
- For category 5: derivatives, of which the counterparty has a low default risk (meaning a counterparty that qualifies for credit quality step 1 or step 2 as set out in Annex VI of the 2006/48/CE Directive), are only eligible if related to cover the interest rate/currency risk of the cover assets or Belgian pandbrieven. Moreover, a group related entity of the Belgian pandbrieven issuer is not eligible as derivative counterparty unless (i) it is a credit institution that benefits from a credit quality step 1 (as defined in Annex VI, points 29 to 32 of the 2006/48/CE Directive) and forms part of the EEA, and (ii) it has a (unilateral) credit support annex (CSA) in place. Note that assets posted under the CSA would belong to the separate legal estate, but are not considered as cover assets as described in this section III. Finally, the derivative contract needs to stipulate that suspension of payments or bankruptcy of the issuer does not constitute an event of default;
- For all of the categories: assets that are delinquent may not be added to the cover pool.

The cover pool can be composed of assets out of each of the five categories. But, per program that is set up, assets out of one of the first three categories (so either residential mortgage loans, commercial mortgage loans or exposure to public sector) need to represent a value of at least 85% of the nominal amount of Belgian pandbrieven. In practice this comes down to three types of Belgian pandbrieven programs that can be set up: residential mortgage covered bond program, commercial mortgage covered bond program or public covered bond program. How such value is determined, is explained in the following section.

IV. VALUATION AND LTV CRITERIA

The valuation rules of the cover assets determine the maximum amount of Belgian pandbrieven that can be issued. The value of the cover assets of each of the categories as mentioned in the section above, will be determined as follows:

- Category 1: minimum of [the outstanding loan amount, 80% of the value of the mortgaged property, the mortgage inscription amount[2]]
- Category 2: minimum of [the outstanding loan amount, 60% of the value of the mortgaged property, the mortgage inscription amount]
- Category 3: value is equal to the book value (nominal amount outstanding), except when the counterparties are not part of the EU in which case the value will be zero. There is however an exception to this zero valuation rule for non-EU counterparty exposure:

  a) in case the non-EU counterparties qualify for credit quality step 1, or

  b) in case the non-EU counterparties qualify for credit quality step 2 and do not exceed 20% of the nominal amount of Belgian pandbrieven issued

  in either case the value is equal to the book value.
- Category 4: no value can be given to this category unless:

  a) the counterparty qualifies for credit quality step 1, or

  b) in case the counterparty qualifies for a credit quality step 2, the maturity does not exceed 100 days as of the moment of registration in the cover pool

  in either case the value is equal to the book value.
- Category 5: no value is given to this category.
- Additional valuation rule applicable to any category: in case of delinquencies above 30 days, the value as determined per category is reduced by 50%. In case of default (> 90 days), no value can be given anymore.

When it comes to property valuation (applicable to categories 1 and 2), in general in Belgium every property is valued during the underwriting process based on either the notarial deed (that includes the property sale price) and/or in case of construction, the financial plan of the architects. It is rather rare in Belgium that the valuation is based on the report of an accredited third party appraiser. In line with the NBB Covered Bonds Regulation, the market value will have to be justified in a clear and transparent manner on the basis of a document established by a person who is independent from the persons who are in charge of granting the relevant loans. An expert report will be required for real estate which has a value of more than 3 million euro or 2% of the amount of the relevant covered bonds. Otherwise, the value of the real estate can be determined on the basis of the sales value as established in the notarial deed at the time of sale or the valuation report of the architect in the case of real estate in construction. The credit institution must apply a prudent revaluation procedure to determine the current value.

The value of the real estate has to be tested regularly. A more regular control shall occur in case of significant changes to the market conditions. To this effect, customary methods and benchmarks (such as third party indices) may be used.

Note that assets can be part of the cover pool without necessarily having a value attached to it, like is the case for the derivatives category but as well for example for risk on financial institutions with a maturity above 100 days and a rating below AA-.

2 This can include Belgian mortgage mandates but upon the condition that there is a first lien mortgage inscription of at least 60% related to one and the same property.

V. ASSET-LIABILITY MANAGEMENT

Each issuer will be required to perform several asset cover tests. The first one has been already mentioned in section III and requires that the value of either category 1, 2 or 3 is at least 85% of the nominal amount of Belgian pandbrieven (the "**85% asset coverage test**"). Secondly, the value of the cover assets needs to exceed the nominal amount of Belgian pandbrieven by 5% at all times (5% overcollateralization) (the "**overcollateralization test**"). Finally the sum of the interest, principal and other revenues needs to be sufficiently high to cover for the sum of interests, principal and other costs linked to the Belgian pandbrieven, as well as any other obligation of the Belgian pandbrieven program (the "**amortization test**").

Next to the asset cover tests, a liquidity test will have to be performed whereby the issuer will calculate its maximum liquidity need within the next 180 days (the "**liquidity test**"). This amount has to be covered by liquid cover assets. A liquidity facility could be used to cover liquidity needs, as long as it is not provided by a group related entity of the issuer. Liquid assets are assets that (i) meet the cover asset eligibility criteria and (ii) qualify as liquid assets under the Regulation of the Banking Finance and Insurance Commission (CBFA) of 27 July 2010 on the liquidity of credit institutions, financial holdings, clearing institutions and institutions assimilated with clearing institutions.

If an issuing credit institution fails to meet the requirements of the liquidity test, it will have 14 days to take the necessary redress measures to meet the relevant requirements. As long as an issuing credit institution has not taken the necessary redress measures, it is not allowed to issue new Belgian covered bonds.

The issuer will also be required to manage and limit its interest and currency risks related to the program and be able to sustain severe & averse interest/exchange rate movements. Although it is the issuer's sole discretion to determine how this will be managed (e.g. adding derivatives to the cover pool is a possibility (subject to eligibility criteria) but not an obligation), it needs to be documented in the license application.

At last it is important to highlight that the tests have to be met on a daily basis.

It is the task of the cover pool monitor to verify at least once a month if the issuer is compliant with all the tests.

Other safeguard mechanisms that are foreseen:

> Issuer will have the possibility to retain its own Belgian pandbrieven for liquidity purposes

> Commingling risk:

a) collections received from cover assets as of the date of bankruptcy or beginning of liquidation will by law be excluded from the insolvent general estate

b) registered collections received from the cover assets before the date of bankruptcy or beginning of liquidation, are part of the separate estate and legally protected via the right of "revindication". This is a special mechanism that has been created to protect cash held by the issuer on account of the special estate. Pursuant to this mechanism, the ownership rights of the special estate as regards cash that cannot be identified in the general estate, will be transferred to unencumbered assets in the general estate that will be selected by taking into account criteria specified in the issue conditions.

> Set-off and claw back risk: solved through the Mobilisation Law.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

In its capacity as a Belgian credit institution licensed to issue Belgian pandbrieven, the issuer is subject to special supervision by the NBB as well as the supervision of a cover pool monitor.

The cover pool monitor:

> Is chosen by the issuer from those persons appearing on the official list of certified/statutory auditors established by the NBB;

> Shall be appointed subject to prior approval from the NBB;

> Can not be the certified/statutory auditor of the issuer.

The main tasks of a cover pool monitor consist of ensuring compliance with legal and regulatory requirements, e.g. are the cover assets duly recorded in the register? do the cover assets fulfil the eligibility criteria? is the value correctly registered? etc. The cover pool monitor is required to perform these tasks not only on an on-going basis, but also prior to the first issuance of Belgian pandbrieven by the credit institution. The on-going verifications must be done at least once a month.

Next to that, the cover pool monitor has a reporting obligation towards the NBB on several aspects such as the level of overcollateralization and the results of the different tests that have to be performed. The issuer is obliged to provide full cooperation to the cover pool monitor and shall give the cover pool monitor the right to review the register, loan documents, accounting book, or any other document. The NBB at its discretion can ask the cover pool monitor to perform other tasks and verifications.

If the NBB considers that a category of Belgian pandbrieven no longer fulfills the criteria or the issuer no longer fulfills its obligations, it can withdraw the license of the issuer and consequently withdraw the issuer from the list of Belgian covered bond issuers. Such a deletion from the list will be reported to the European Commission but does not have consequences for existing Belgian pandbrieven holders.

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

Assets need to be registered before they form part of the segregated estate. The law protects these registered assets (including all collateral and guarantees related to such assets) in the segregated estate from the creditors of the insolvent general estate, so they are therefore not affected by the start of insolvency proceedings against the issuer. Also, any assets that would be posted via a CSA that is in place would be protected from insolvency proceedings, as it is required to register these type of assets as well, although as explained before one cannot consider those as pure cover assets.

The cover assets once registered are exclusively and by operation of law reserved for the benefit of the Belgian pandbrieven investors and other creditors that might be linked to the program (e.g. a swap counterparty of which the derivative is included in the cover pool). These creditors also have a claim on the general estate. Only when all obligations at program level have been satisfied, will any remainder of assets of the separate legal estate return to the general estate of the issuer. The bankruptcy receiver of the credit institution, in consultation with the NBB, could ask the restitution of cover assets if and when there is certainty that not all assets will be necessary to satisfy the obligations under the Belgian pandbrieven program.

Upon the initiation of bankruptcy proceedings or the adoption of a reorganization measure against the credit institution, or even before whenever the NBB considers it to be necessary (e.g. at the moment the license is withdrawn), a cover pool administrator ("gestionnaire de portefeuille") will be appointed that will take over the management of the Belgian pandbrieven program from the credit institution. The cover pool administrator (appointed by the NBB) is legally entrusted with all powers that are necessary for the management of the special estate, and can take all such actions (some in consultation with/upon approval of both the NBB and the representative of the noteholders) required to fulfill in a timely manner the obligations under the Belgian pandbrieven. Such actions could consist in (partial) sale of the underlying cover assets, taking out a loan, issuance of new bonds to use for ECB purposes or any other action that might be needed to fulfill the obligations. Acceleration of the Belgian pandbrieven is not possible, unless:

> Noteholders would decide otherwise;

> It is clear that further deterioration of the cover assets would lead to a situation whereby it is impossible to satisfy the obligations under the Belgian pandbrieven (i.e. in a situation of insolvency of the cover pool).

The bankruptcy receiver has a legal obligation to cooperate with the NBB and the cover pool administrator in order to enable them to manage the special estate in accordance with the law.

The Cover Pool Administrator Royal Decree specifies the tasks of the cover pool administrator. These include, amongst other things, the payment of interest and principal on the Belgian covered bonds, collection of moneys from the cover assets (including any enforcement), entering into relevant hedging and liquidity transactions and carrying out of certain administrative tasks. The cover pool administrator will also have to test compliance with the cover tests and inform the NBB and the noteholders' representative thereof.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Belgian pandbrieven will comply with the requirements of Art. 52 par. 4 UCITS Directive and of the CRD Directive, Annex VI, Part 1, Paragraph 68 a) to f) if and to the extent they are listed by the NBB as such.

> Figure 1: Covered Bonds Outstanding, 2003-2012, EUR m

Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2012, EUR m

Source: EMF/ECBC

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/100/Belgium_Covered_Bonds

3.4 BULGARIA

By Yolanda Hristova, UniCredit Bulbank
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I. FRAMEWORK

In Bulgaria, the legal basis for the issue of covered bonds is the Mortgage-backed Bonds Law issued by 38th National Assembly on 27 September 2000, published in the State Gazette (Darzhaven vestnik) issue 83 of 10 October 2000[1].

Ordinance No 8 of Bulgarian National Bank on the Capital Adequacy of Credit Institutions[2] treats the risk weighting of other types of covered bonds.

II. STRUCTURE OF THE ISSUER

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

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

> Housing units, including leased out;

> Villas, seasonal and holiday housing;

> Commercial and administrative office spaces, hotels, restaurants and other similar real estate; and

> Industrial and warehousing premises.

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

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

III. COVER ASSETS

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

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

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

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

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

1 Amended; issue 59 of 2006; in force on the date of entry into force of the Treaty of Accession of the Republic of Bulgaria to the European Union; amended; issues 52 and 59 of 2007; amended; issue 24 of 2009; effective as of 31 March 2009

2 Adopted by the Bulgarian National Bank, published in the Darjaven Vestnik, issue 106 of 27 December 2006, in force as of 1 January 2007; amended, issue 62 of 2007; amended, issue 38 of 2008, effective as of 11April 2008; amended, issue 21 of 2009; amended, issues 20, 85 and 102 of 2010; amended, issue 95 of 2011 (http://www.bnb.bg/bnbweb/groups/public/documents/bnb_law/regulations_8_credit_instit_en.pdf)

- > Claims fully backed by government securities issued by the Government of the Republic of Bulgaria, the Bulgarian National Bank, the Governments, Central Banks or international institutions;
- > Claims secured by gold; and
- > Claims fully backed by bank deposits denominated in Bulgarian levs or in a foreign currency for which the BNB quotes daily a central exchange rate.

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

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

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

IV. VALUATION AND LTV CRITERIA

Valuation

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

For appraisals of the property the comparative method, the revenue method and the cost-to-make method shall be used for the purposes of the law.

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

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

- > Have outstanding liabilities exceeding 1% of the issuing bank's own funds; or
- > Have not been consistently classified as standard risk exposures throughout that period.

LTV criteria

LTV criteria are generally defined in the banks own lending policies depending on their risk appetite and other internal rules. No specific legal requirements are imposed by the local banking law.

V. ASSET - LIABILITY MANAGEMENT

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

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

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

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

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

VI. TRANSPARENCY

Banks (the only eligible issuers of mortgage bonds) produce regular reporting to Banking Supervision authority – Bulgarian National Bank (BNB), and provide and publish financial information on a monthly basis. The public banks are reporting issuers and submit all required information to the regulated market – Bulgarian Stock Exchange – Sofia (BSE), as well as to the Bulgarian Financial Supervision Commission (FSC). No additional specific measures in respect to the mortgage bonds are currently announced.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Cover pool is managed by the issuing bank which should have adopted internal rules for maintaining the cover pool, the rules for access to the cover pool data base and the regularity of the update of the cover.

Bulgarian National Bank carries out general assessment of the banks, including issued mortgage bonds as part of general banking supervision.

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

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

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

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

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

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

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

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

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

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Risk weighting

Exposures in the form of covered bonds are treated in article 41 of Ordinance No.8 of Bulgarian National Bank on the Capital Adaquacy of Credit Institutions.

Exposures in covered bonds shall receive a risk weight one step more favourable than a senior unsecured exposure to the issuing bank in accordance with the *Standardised Approach to Credit Risk*.

Risk weights for exposures to covered bonds under Standardised approach:

> Risk weight of the issuer's first-rate unsecured debt 20% 50% 100% 150%

> Risk weight of the exposure 10% 20% 50% 100%

Risk weights for exposures to covered bonds under Foundation IRB (Internal Rating Base approach):

Loss Given Default (LGD) values for Exposures to Central Governments, Central Banks, Corporates and Institutions:

> Senior exposures without eligible collateral: 45%;

> Subordinated exposures without eligible collateral: 75%;

> Covered bonds as specified in Article 41, paragraphs 2–4 (where mortgage bonds fall): 11.25%

Covered bonds shall be secured by any of the following eligible assets:

> Exposures to or guaranteed by central governments, central banks, public sector entities, regional governments and local authorities in the EU Member States;

> Exposures to or guaranteed by non-EU central governments, non-EU central banks, multilateral development banks, international organisations that qualify for the credit quality step 1 and step 2 as set out below:

Credit quality step	1	2	3	4	5	6
Risk weight	0%	20%	50%	100%	100%	150%

and exposures to or guaranteed by non-EU public sector entities, non-EU regional governments and non-EU local authorities that are risk weighted as exposures to institutions or central governments; where these exposures qualify for the credit quality step 2, the exposure shall not exceed 20% of the current nominal amount of issued covered bonds of the issuing credit institution;

> Exposures to institutions that qualify for credit quality step 1. The exposure shall not exceed 15% of the current nominal amount of the issued covered bonds of the issuing credit institution; exposures to EU-institutions that meet the step-2 credit quality requirement shall be included provided their residual maturity is less than 100 days;

> Loans secured by mortgage on a residential property, to the lower of the amount of the pledge or 80% of the value of the property;

> Senior shares in a special purpose (securitisation) entities governed by the laws of a Member State, securitising residential real estate exposures provided that at least 90% of the assets of such entities are composed of a mortgage of residential real estate and to the lower of:

a) Nominal value of the shares;

b) Value of the pledge;

c) 80% of the value of the property pledged.

> Loans secured by a mortgage on a commercial real estate, to the lower of the amount of the pledge and 60% of the value of the property;

> Senior shares in a special purpose (securitisation) entities governed by the laws of a Member State, securitizing commercial real estate exposures provided that at least 90% of the assets of such entities are composed of a mortgage of commercial real estate and to the lower of:

a) Nominal value of the shares;

b) Value of the pledge;

c) 60% of the value of the property pledged.

The shares under the fifth item above (senior shares in a special purpose) shall have an assigned credit quality step one and not exceed 10% of the nominal amount of the outstanding issue. Exposures caused by transmission and management of payments of the obligors of, or liquidation proceeds in respect of, loans secured by pledged properties of the senior units or debt securities shall not be comprised in calculating the 90% limit from items 5 and 7 above. The covered bondholders' claims shall take priority over all other claims on the collateral.

Compliance with European Legislation

Mortgage-backed Bonds Law is compliant with the requirements of Art.52 par.4 UCITS Directive as well as with those of the CRD Directive, Annex VI, Part 1, Paragraph 68.

X. ADDITIONAL INFORMATION

Minimum information requirements for issuance prospectuses

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

> The Rules of the issuing bank concerning the contents, the entry and deletion procedures as well as the terms and procedures authorizing access to the register and its internal rules of conducting and documenting mortgage appraisals;

> Data on mortgage loans held in the issuing bank's portfolio on the basis of which an issue is being made, including for each loan:

a) The size of the outstanding principal at the time of extending the loan and by the end of the most recent full quarter;

b) Loan life at the time of extending the loan and the remaining term to maturity;

c) Interest rates, fees and commissions on the loan;

d) Risk classification of the loan by the end of each calendar year from the time it was extended and by the end of the most recent full quarter;

e) Type of real estate mortgaged as collateral, their mortgage appraisal value and the ratio between the outstanding principal and the mortgage appraisal value at the time of extending the loan and by the end of the most recent full quarter;

> Characteristics of the mortgage loan portfolio on the basis of which the issue is made, including a distribution of loans by:

a) The size of the outstanding principal;

b) The residual term to the final repayment of the loan;

c) Interest rate level;

d) Their risk classification by the end of the most recent full quarter; and

e) The ratio between the outstanding principal and the most recent mortgage appraisal value of the real estate pledged as collateral.

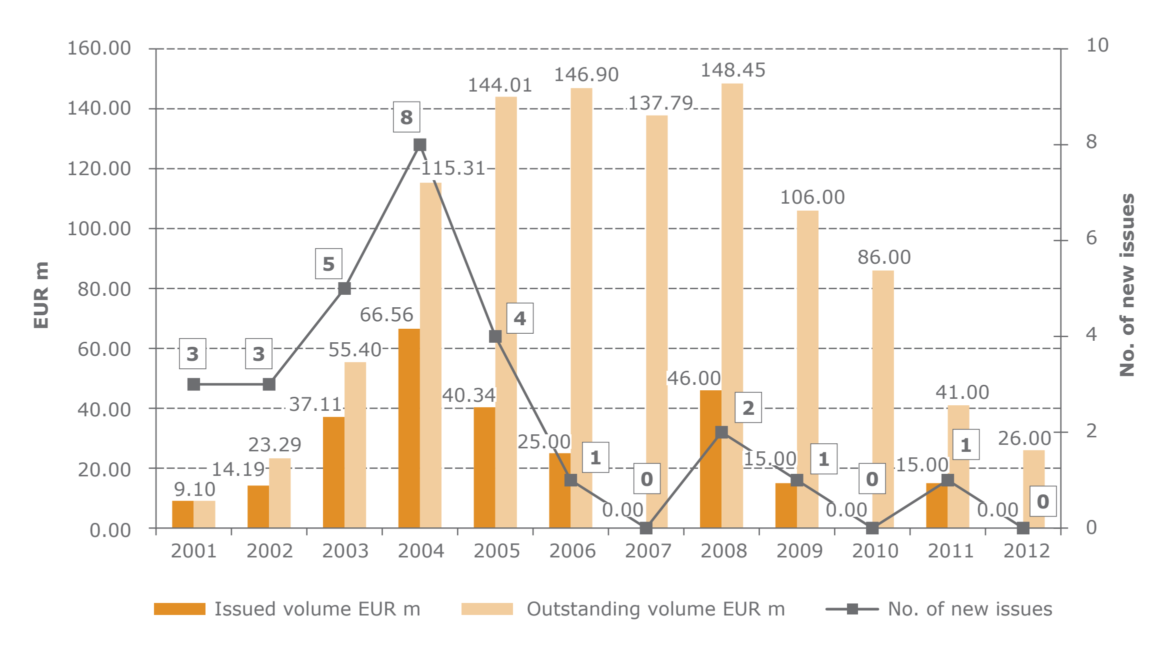
In public offerings of mortgage-backed bonds the provisions of the Public Offering of Securities Act (POSA) and the Ordinances on its enactment shall apply. In non-public offerings of mortgage-backed bonds the provisions of Commerce Law shall apply.

Bulgarian Mortgage Bond Market Information

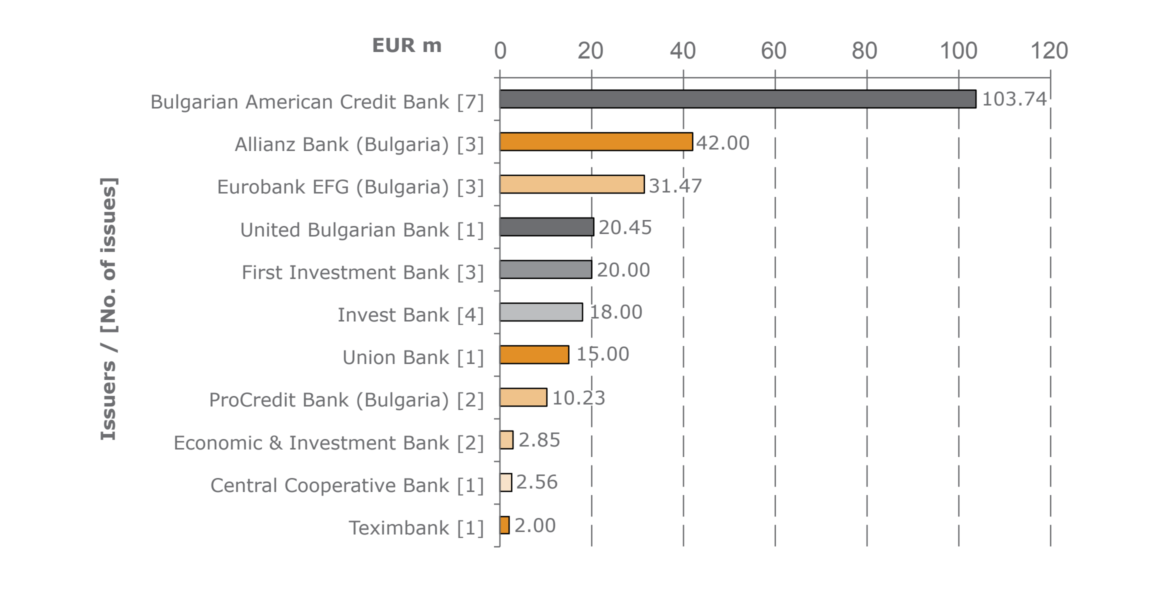
Since the adoption of the Bulgarian Law on Mortgage-backed Bonds in 2000 the mortgage bond issues in Bulgaria total 28. There were no new issues in 2012. The volume of issued mortgage-backed bonds is EUR 268.3 m originated by 11 issuing banks. As of 31 December 2012 the outstanding mortgage bonds amount to EUR 26 m[3].

3 Source: Central Depository, UniCredit Bulbank's own database

> Figure 1: Mortgage Bond Issues in Bulgaria, 2001-2012



> Figure 2: Mortgage Bond Issuers in Bulgaria, 2001-2012



ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/72/Bulgarian_Covered_Bonds

3.5 CANADA

By Anne Caris, Bank of America Merrill Lynch

I. FRAMEWORK

Canada implemented dedicated covered bond legislation in 2012 with the amendment of the National Housing Act[1] in June followed by additional requirements defined by the Canada Mortgage and Housing Corporation (CMHC)[2] in December. The CMHC is responsible for the administration and supervision of Canada's new "registered" covered bonds. New covered bond issuance is restricted to "registered" covered bonds so that non-registered or structured covered bonds ("historical" bonds in the CMHC guide) will remain managed in separate programmes and amortise gradually until September 2017.

The new legal framework, for the most part, codifies the terms within the existing Canadian structured covered bond programmes – except for one major amendment. Under the new law, Canadian insured mortgages are no longer eligible as collateral – therefore underpinning the establishment of new covered bond programmes (only covered bonds by Royal Bank of Canada have been backed by non-insured residential mortgages as of mid-year 2013).

The covered bond issuance limit of 4% of total assets, which was put in place in June 2007 by the Office of the Superintendent of Financial Institutions (OSFI), is unchanged. The OSFI regulates Canadian financial institutions. Details below are related to Canadian "registered" covered bonds under the new law. For information on Canadian "contractual" covered bonds please see the 2012 ECBC European Covered Bond Fact Book.

II. STRUCTURE OF THE ISSUER

Permitted issuers of Canada's new "registered" covered bonds consist of banks, trust and loan companies, cooperative credit associations and insurance companies. A special licence must be provided by the CMHC upon fulfilment of the minimum legal requirements together with adequate over-collateralisation (OC) levels to ensure sufficient collateral and appropriate risk management systems. Furthermore, issuers must have no specific regulatory issue. The CMHC may suspend the right of issuing "registered" covered bonds in case of a breach of legal requirements that is not remedied.

Canadian "registered" covered bonds are direct and unconditional obligations of the issuer. In the event of issuer insolvency or default, investors have a claim over the pool of cover assets. The cover assets are held in a bankruptcy-remote special-purpose entity, the guarantor, which provides a direct, unconditional and irrevocable guarantee in respect of due interest and principal payments under the covered bonds that would otherwise be unpaid by the respective issuer. In Canada, the guarantor is either set up as a limited liability partnership or a trust (an alternative guarantor form might be allowed by the CMHC under specific conditions). A bond trustee (which has to be independent and bankruptcy remote from the issuer) must be designated to represent the views and interests (and enforce the rights) of covered bond holders.

Cover assets are segregated from the issuer through a legal true sale between the issuer and the guarantor. Legal title to the mortgages typically remains with the issuer and is only transferred to the guarantor in the case of: (1) material breach or default by the issuer; (2) impending or actual issuer insolvency; (3) material breach or default by the servicer of eligible loans; or (4) any other event as prescribed in the transaction document. Borrowers are notified of the sale of the mortgages to the guarantor upon such triggers. Each "registered" issuer must engage a bankruptcy-remote custodian with appropriate systems and knowledge of handling mortgages. The guarantor must provide the custodian with the details of eligible and substitute assets, as should the issuer (in electronic form) on a quarterly basis when solvent.

1 See National Housing Act R.S.C., 1985, c. N-11

2 See CMHC's Canadian Registered Covered Bond programmes Guide (www.cmhc-schl.gc.ca)

III. COVER ASSETS

Eligible assets for Canadian "registered" covered bonds mainly consist of residential mortgages for properties (of no more than four residential units) located in Canada. These must be non-insured, first ranking and with a maximum 80% loan-to-value. Loans with one or more payments in arrears (whether on interest or principal) should be excluded from the cover pool and bought back by the issuer. Furthermore, to qualify as cover assets, one or more payments must have been made according to the terms of the loans (whether interest and/or principal). Eligible loans must also be originated by the issuer or meet its underwriting criteria.

Substitute assets can be included in the cover pool but cannot exceed 10% of cover assets. They must be Canadian government bonds or any other prescribed assets. The guarantor may also hold cash of a total amount not exceeding its payment obligations in the next six months.

IV. VALUATION AND LTV CRITERIA

Property values should be indexed at least on a quarterly basis. The indexation methodology for a covered bond programme must be disclosed to investors and in line with any regulatory requirement on or before 1 July 2014. Loans are accounted up to the 80% LTV cap. In Canada, a property value has to be assessed during the underwriting process. The valuation is either performed by an accredited third-party property appraiser or information on the property value is obtained from an independently maintained valuation model based on similar properties recently sold in the same area.

V. HEDGING AND ASSET - LIABILITY MANAGEMENT

Within covered bond programmes, there is an inherent liquidity mismatch due to the bullet payment nature of the covered bonds and the cash flows generated from the cover assets. Following a default by the issuer, the principal cash flows generated from the cover assets may not be sufficient to ensure timely repayment of the outstanding covered bonds. To mitigate this credit and liquidity risk, legal frameworks typically incorporate a minimum over-collateralisation (OC) requirement. Canada has opted out of a national minimum requirement. Instead, "registered" issuers must establish a minimum and maximum OC level in their respective covered bond programme. This is more tailored-made while the maximum OC limit eliminates uncertainty regarding available OC to covered bond holders. The maximum OC level should be subject to a contractual covenant of the "registered" issuer in favour of covered bondholders and can only be amended upon the approval process prescribed by the relevant transaction document.

Furthermore, the guarantor is required to put in place covered bond collateral hedges (if not there already) at the time of each transfer of covered bond collateral or covered bond issue in order to minimise interest rate or FX mismatches. It may also enter into contingent covered bond collateral hedges, which become effective, e.g., in case of an event of default of the "registered" issuer. The guarantor carries out monthly valuations to assess market risks[3]. Hedging counterparties must meet CMHC counterparty requirements including minimum standards established by rating agencies. The terms of each transaction document must explicitly state that the guarantor may replace a specific counterparty upon rating triggers or in case of an event of default of the "registered" issuer. The CMHC must be informed of counterparty replacement, termination or resignation. Swap counterparty ranks pari passu with covered bondholders (or senior at the discretion of the guarantor).

A cash reserve might be required for the benefit of the guarantor upon specific rating triggers. It is sized to meet in full interest payments on outstanding covered bonds together with all payment obligations of the guarantor entity ranking prior to such interest payments – under the aforementioned six-month limit. It is retained in

3 This measures the present value of the covered bond collateral versus the market value of the outstanding covered bonds (in Canadian dollars).

a bank account and, following an issuer event of default, the balance of the cash reserve forms part of available revenue receipts to be used by the guarantor to meet its obligations under the covered bond guarantee.

Typical of SPV structures, Canadian issuers must meet the following tests on a monthly basis:

> **Asset Coverage Test (ACT):** The ACT determines whether the issuer meets the pre-determined minimum and maximum OC levels. An asset monitor also tests the accuracy of the ACT calculation yearly, or more frequently under specific circumstances.

> **Pre-Maturity Test (PMT):** The PMT ensures that the covered bond collateral includes sufficient cash to meet in full all principal payments due under all outstanding covered bonds (together with all other payment obligations ranking in priority) for a period prescribed in the transaction documents of the specific programme.

> **Amortisation Test (AT):** Following an issuer event of default, the AT ensures that the value of cover assets is at least equal to the outstanding covered bonds.

VI. TRANSPARENCY

The Canadian covered bond legal framework is prescriptive in terms of information disclosure and reporting. Requirements (which meet the minimum standards established under ECBC's Covered Bond Label) include the following:

> All material information related to a "registered" issuer and covered bond programme must be accessible on an ongoing basis, mainly through a dedicated website set up by the issuer. All transaction documents should be available on the website.

> A monthly report must be prepared within 15 business days of the end of each month and include detailed information on the covered bond programme (e.g. key parties/counterparties, ratings, event of default occurrence, credit enhancement and rating triggers, statistics related to cover asset and covered bonds, material issues and deficiencies).

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Canadian "registered" covered bonds are supervised by the CMHC. Issuers are required to appoint a cover pool monitor (CPM) with adequate qualifications. The responsibilities of the CPM consist of ensuring the accuracy of the records regarding the cover pool and the adequacy of the required tests. Results should be reported to the CMHC and the bond trustee annually or whenever deemed reasonable. Issuers should make available all information needed by the CPM. Following issuer insolvency, the CPM remains in place for the benefits of the guarantor. "Registered" issuers must provide immediate notice to the CMHC in case of: (1) a failed ACT and/or AT; (2) awareness of a rating downgrade/ withdrawal/trigger; and (3) a breach or default under the terms of the covered bond programme.

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

The guarantor is structured as a bankruptcy-remote, special-purpose entity and, as such, following insolvency of the issuer, all the assets of the guarantor are segregated from those of the bankrupt estate of the issuer.

> Upon an issuer event of default, the guarantor is required to meet the covered bond obligations using the cash flows generated from the cover assets. In case of insufficient cash, the guarantor is permitted to sell the cover assets, find alternative funding or enter repos. The entire pool of cover assets is available as security for all the outstanding covered bonds issued under the programme, so there is no direct link between particular assets and a specific series of covered bonds.

> Upon a guarantor event of default, covered bonds accelerate. Preferential rights are limited to the guarantor's assets, although, if cover assets are insufficient, covered bond holders have recourse to the assets of the issuing entity ranking pari passu with ordinary depositors and unsecured debt holders. Payments are made in accordance with the applicable order of priority.

An issuer or guarantor event of default include at a minimum (other events maybe prescribed in the documentation) the following: (1) the commencement of dissolution or bankruptcy proceedings, which are not dismissed within 60 days of the filing date; (2) failure to pay the principal or any amount due under the covered bond programme; (3) failure to comply with the remedial action following a rating trigger; and (4) failure to meet the AT by a guarantor. A remedy period of 10 business days may be considered in case of default on principal payments versus 30 days on default of interest or other payment.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Canadian covered bonds are not UCITS 52(4)-compliant or CRD-compliant as Canada is not a member of the EU. Therefore, they do not benefit from a preferred risk-weighting for regulatory capital purposes. Under the Standardised Approach, they are treated similarly to senior unsecured bank debt. That said, if denominated in €/£/¥/US$, Canadian covered bonds are eligible for European Central Bank repo operations, conditional on an investment-grade rating. Specific haircuts are applied depending on the rating and characteristics of the covered bond.

X. ADDITIONAL INFORMATION

Explicit rating requirements and triggers

A "registered" covered bond programme must have no less than two ratings at all times by DBRS, S&P, Fitch, Moody's or any other credit agency recognised by the CMHC. Rating triggers must be prescribed for: (1) the replacement of counterparty as relevant; (2) the collateralisation of covered bond collateral hedge counterparties; (3) the coming into effect of contingent covered bond collateral hedges; (4) the establishment of a cash reserve; (5) the end of the period in which the commingling of the guarantor entity's cash with that of the "registered" issuer, servicer or cash manager is permitted. All rating triggers must be subject to a contractual covenant on the part of the party required to take the relevant remedial action in a transaction document of a "registered" covered bond programme.

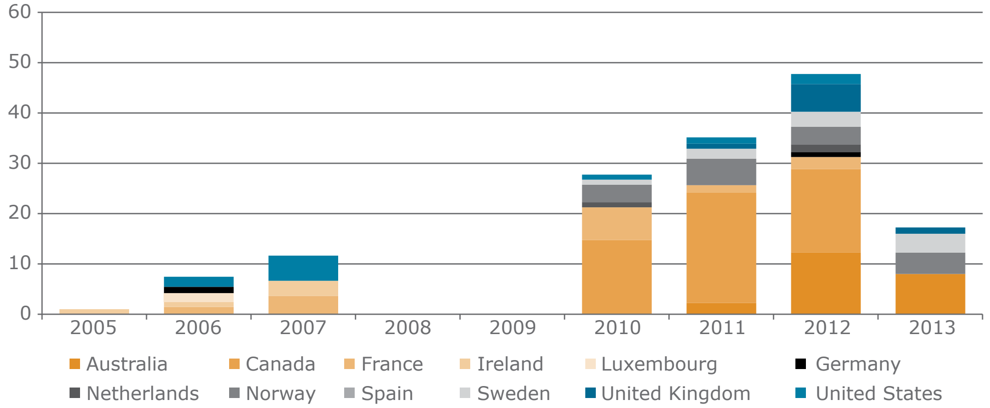
New asset class: an evolution, not a revolution

The elimination of insured mortgages from the assets securing covered bonds has been driven by Canada's national cap on insured housing loans, which was close to being reached. The system of insured loans was put in place to facilitate access to the property market while safeguarding financial stability. The shift from insured to uninsured mortgages is an important evolution for the Canadian covered bond market. However, given the current characteristics of the Canadian mortgage market and banking sector, the implications are likely to be limited.

Immaterial for the size of the covered bond market

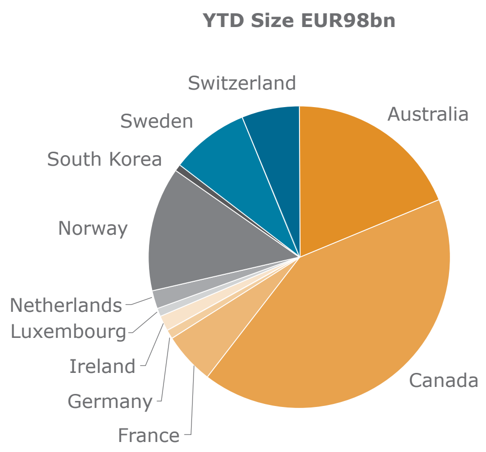
Canadian issuers have been major contributors to the growth of the USD-denominated covered bond market since 2010 (see Figure 1 & 2). New legislation, which requires issuers to set up new "registered" covered bond programmes, led to a smaller contribution in 2012 and none at all so far this year. One exception is Royal Bank of Canada, as its covered bond programme is already backed by uninsured mortgages. Following full implementation of the new covered bond programme, Canadian banks should to remain major issuers and maintain a key market share of the USD-denominated market in light of their covered bond maturity profiles and overall funding needs. Maturing covered bonds for Canadian issuers in USD only amount to about USD 50bn in the next four years. Current non-registered covered bond programmes will amortise until 2017.

> FIGURE 1: USD-DENOMINATED BENCHMARK ISSUANCE BY COUNTRY YTD BY END-MAY 2013 (USD BN) [1]



Source: BofA Merrill Lynch Global Research; [1] Excluding FRNs

> FIGURE 2: USD-DENOMINATED OUTSTANDING BENCHMARKS BY COUNTRY YTD (%)



Source: BofA Merrill Lynch Global Research; [1] Including taps; excluding FRNs

Canadian banks have CAD 63bn covered bonds currently outstanding, having tapped, over the past several years, what has proved to be a receptive source of funding (see Figure 3). Covered bond issuance in Canada is limited to a maximum of 4% of total assets, and the current remaining capacity for the banks is about CAD 84bn (gross). New requirements in terms of eligible assets are not an obstacle. Based on recent data, banks have enough uninsured mortgages on their balance sheets to do so. Canadian banks should also be able to refinance their maturing bonds, especially as maturities are spread over the next four years, which should allow them to build up their uninsured mortgage exposures. The real hurdle for Canadian banks in terms of future issuance is the 4% issuance limit – the strictest across covered bond markets – rather then the amount of eligible assets.

Figure 3: Covered bond issuance capacity vs. outstanding amounts

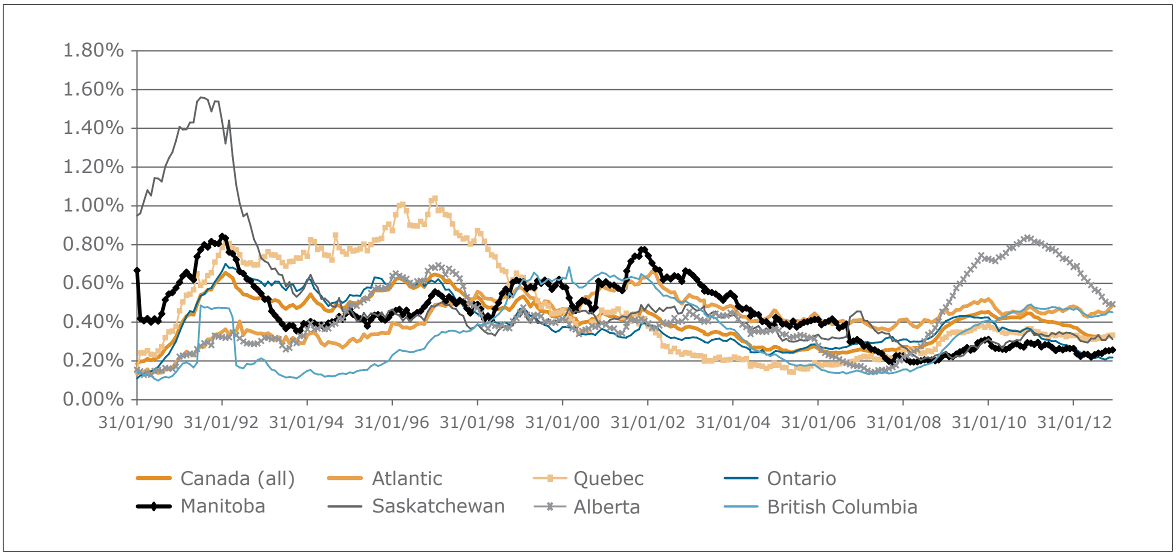
31 Jan 2013 (CAD bn)	RY	BMO	BNS	CM	CCDJ*	NA	TD	Total
Max. covered bond issuance limit [1]	34	22	29	16	7	7	33	147
Outstanding covered bonds	11	8	16	14	2	3	10	63
Remaining issuance capacity (gross)	**23**	**14**	**14**	**2**	**5**	**4**	**23**	**84**
Total mortgages	195	79	188	144	86	44	155	890
Outstanding uninsured mortgages	**78**	**29**	**79**	**35**	**n/a**	**20**	**50**	**291**

Source: BofA Merrill Lynch Global Research, company reports; [1] 4% of total assets; * data as of 1Q13

Limited impact on the quality of cover pools

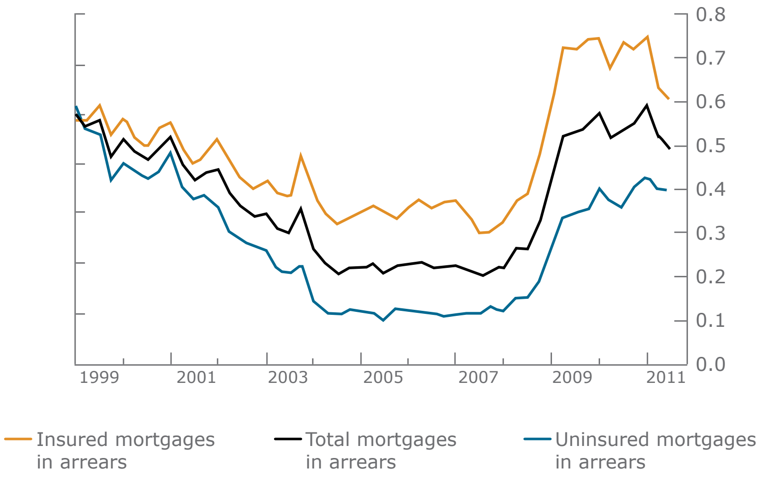
Following the exclusion of insured mortgages from cover pools, Canadian covered bond programmes are shifting from public-sector type to traditional residential mortgage type – in line with other markets. However, risks for investors should remain contained considering the performance of the Canadian housing market. Non-performing loans have been low historically across provinces despite a few peaks related to the economic reliance of some areas on the energy or commodity sectors, resulting into macroeconomic volatility (see chart below). Comparing uninsured with insured residential mortgages also shows that both products are of prime quality, as reflected in similar NPL levels (see Figure 4 & 5).

> Figure 4: % arrears in residential mortgages*



Source: Canadian Bankers Association; *arrears= non-performing loans ≥3 months

> Figure 5: Insured vs uninsured arrear levels (%)



Source: Bank of Canada

The nature of the Canadian mortgage market may partly explain why mortgage arrears have remained low through the business cycle:

- Mortgages in Canada are typically full-recourse, meaning that the borrower remains liable for the amount of the mortgage even in the case of foreclosure.
- Underwriting criteria have been prudent overall – with affordability being a major criterion – including for HELOCs[4], which are subject to a maximum LTV for each borrower determined during the underwriting process. Recent underwriting guidelines published by the OSFI in June 2012 reinforced this aspect (see below).
- Mortgages in Canada do not benefit from tax deductibility so that households have the incentive to amortise their debt.
- Origination is mostly done by Canadian banks themselves with limited participation from brokers. Risks remain on balance sheet and banks' strategy typically targets a long-term and full-range product relationship with their customers.

<u>Recent regulation to protect the property market</u>

Furthermore, Canada benefits from prudent and hands-on supervision, reflected in the successive measures introduced by regulators to safeguard a sound property market. Important measures were taken in June 2012.

- <u>New mortgage lending origination limits</u>

  These consist of: (1) maximum amortisation period reduced to 25 from 30 years; (2) maximum LTV when refinancing lowered to 80% from 85%; (3) maximum gross debt-service (GDS) and total debt-service (TDS) ratios fixed at 39% and 44%, respectively (see definitions below); (4) limited availability of government-backed insured mortgages to homes with a purchase price of less than USD1mn.

4 Home Equity Line of Credits

> New requirements for mortgage underwriting practices and procedures

These requirements aim to ensure adequate assessment of borrowers' willingness and ability to repay their debt on time and/or of the underlying property value/collateral. Non-compliance with the guidelines may lead to specific action by the OSFI. Requirements are notably prescriptive with respect to:

> Loan documentation, which should include the loan purpose; employment status and income verification; debt-service ratio calculations and verification documents; LTV ratio and property valuation/appraisal documentation; credit bureau reports; proof of the source of the down payment, purchase/sale agreements; a clear rationale for the lending decision; and records from the mortgage insurer if any.

> The GDS ratio, which aims to assess monthly housing-related costs, should include specific items (principal and interest, other sources of income, heating costs, property taxes, guarantor or co-signer income, monthly payments from other credit facilities). The TDS, which estimates the total debt burden, should consist of housing-related expenses, any other living cost/recurring payment obligations (eg, condominium fees), the borrower's assets, etc. These should be stressed for negative outcomes and discount temporary items (eg overtime wages).

> By law residential mortgages for purchasing, renovating or improving a property must be insured if the LTV exceeds 80%. The LTV of non-conforming residential loans (typically because of low credit scores, high debt serviceability ratios, illiquid properties, etc) and of non-amortising HELOCs is capped at 65%.

> Disclosure, with quarterly reporting on: (1) the amount and percentage of total residential mortgages and HELOCs (both insured and uninsured); (2) amortisation periods; (3) the average LTV ratio for the new/acquired mortgage loans with a breakdown by region; and (4) comments regarding the impact of an economic downturn.

Issues to consider

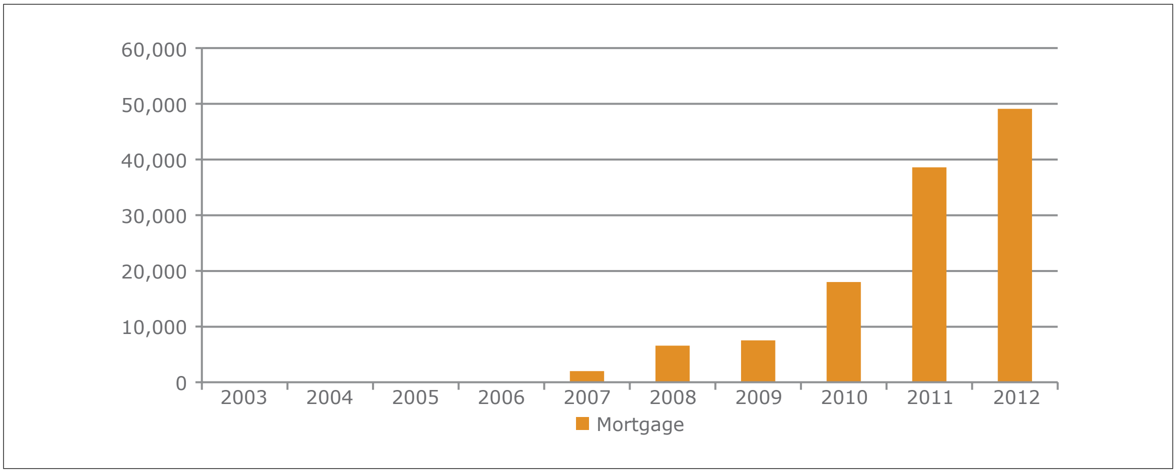
Listed below are the main risks identified for the Canadian mortgage market and covered bonds and some of the key issues to consider:

> Rising interest rates is of one of the main risks for households, as is unemployment – a sharp rise in both indicators seems unlikely in the foreseeable future, however. Fixed-rate mortgages are reset every five years or less at the prevailing interest rate, resulting in some interest rate exposure.

> Regional concentration may alter the performance of the underlying mortgages and ultimately the quality of the cover pools given differences in the economic characteristics/growth of Canadian provinces – eg, with some being more reliant than others on commodities, as mentioned above.

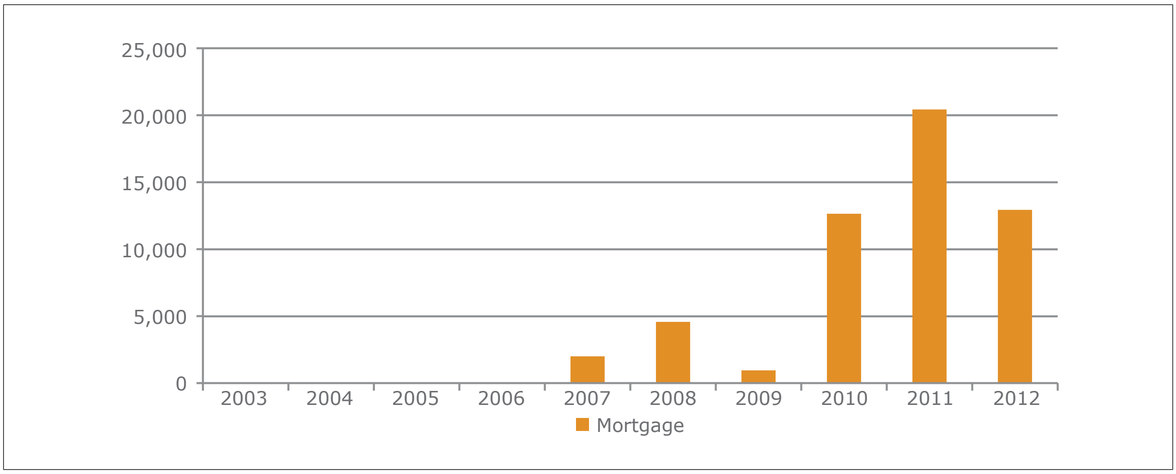
> Product differences might need to be taken into account. While mortgage loans tend to be full recourse, as previously mentioned, in some provinces (eg, Alberta, Saskatchewan) the recourse might be limited to the property only in specific circumstances. This could negatively impact the probability of default and severity of loss of such loans.

> Figure 6: Covered Bonds Outstanding, 2003-2012, EUR m



Source: EMF/ECBC

> Figure 7: Covered Bonds Issuance, 2003-2012, EUR m



Source: EMF/ECBC

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/12/Canadian_Covered_Bonds

3.6 CHILE

By Antonio Procopio, Emiliano Muratore
and Emiliano Urrutia, Banco Santander Chile

I. LEGAL FRAMEWORK

The legal framework for Chilean covered bonds (*Bonos Hipotecarios*, also BHs) is determined by:

> The General Banking Law (Ley General de Bancos, LGB): Article 69, n°2, BH issuances; and Articles 125, 126 and 134, special treatment of banking entities under bankruptcy.

> The Chilean Central Bank: Financial Regulation Compendium (*Compendio de Normas Financieras*, CNF), Chapter II.A.2, Chilean Central Bank complementary rules.

> Superintendency of Banks (*Superintendencia de Bancos e Instituciones Financieras*, SBIF): *Recopilación Actualizada de Normas* (RAN), Chapter 9-2, Complementary rules of the Chilean banking regulatory agency.

In 2010, Law 20.448 – also called MKIII, the third reform to the Capital Markets Law — introduced a series of changes in terms of liquidity, financial innovation and integration of the capital markets. Among them was the amendment of Article 69, n°2 of the LGB which enabled banks to issue bonds with no special guarantees, called BHs. These securities are specifically aimed to raise funds for the origination of mortgage loans (*mutuos hipotecarios*) used to finance the acquisition, construction, repair or extension of residential properties. Only residential mortgages for these purposes are accepted as collateral, excluding commercial, public or other types of loans. An additional restriction imposed to define an eligible mortgage is that only new mortgages are accepted. Hence, a maximum time limit of 18 months was set for the origination of eligible loans since the date of the BH's issuance. Thus, BH bonds also have an anticipated rescue clause for a proportional prepayment of the bond in case of insufficient origination. The issuer has the flexibility of an additional one month period to incorporate new mortgage loans of the same nature and quality to comply with the cover asset limit and balance principle at the end of this 18 months allocation period and at the end of each month along the life of the bond.

Under an eventual credit event/default of an issuer, Articles 125, 126 and 134 of the LGB give BHs the same treatment and current legal status as that of outstanding *Letras Hipotecarias* (LH), a type of mortgage bond frequently used by Chilean banks in the past to finance their mortgage business. These articles regulate the procedures in such case and the mechanisms for the tender process and subsequent transference of eligible loans/assets and liabilities from the defaulted issuer to a new entity.

In September 2012, the final regulation was published in a joint statement by the Chilean Central Bank and the SBIF, describing BHs as a new source of long term funding for banking entities, thus allowing better conditions for clients as well as a new investment alternative for institutional investors. At the same time it explicitly incorporated a prudential regulation associated with financial stability objectives. In particular it stated the obligation of periodic reporting of both bonds and loans, the definition of certain credit indicator limits, specific policies to grant loans and other transparency objectives for the benefit of both clients and investors.

Chapter II.A.2 of the CNF regulates issues related with eligible loans, as well as investments in fixed income securities as substitute collateral since the date of issuance during the period of loan origination, specifying limits for compliance during the whole life of the bond.

The SBIF's RAN mainly regulates the issuance of BHs, the relationship between bonds and loans, and the establishment of a special Register for further control which includes detailed up-to-date information to comply with transparency and monthly reporting objectives.

II. STRUCTURE OF THE ISSUER

Under current legislation only banking entities are allowed to issue *Bonos Hipotecarios*. Cover assets are held within the balance sheet with the proper internal controls to monitor the cover pool and its relationship with its related bond ratios and limits over time.

Banco Santander Chile is the first Chilean bank currently in the process of issuing a BH bond.

III. COVER ASSETS

Regulation states that issuers have 18 months since the bond's date of issuance to allocate the resources to the origination of mortgages. After that period, at the end of each month during the life of the BH, the outstanding balance of mortgages, excluding amounts in arrears, should not be lower than 90% of the outstanding balance of the respective bonds. Any difference between the outstanding amounts of the mortgages and the bonds must be covered by high credit quality fixed income instruments.

FIGURE 1: FIXED INCOME SUBSTITUTE COLLATERAL: MINIMUM 80% IN SOVEREIGN BONDS (CATEGORIES: I. AND II.)

I.	Sovereing bonds	Fixed income instruments issued by Chilean central bank.
II.	Sovereing bonds	Fixed income instruments issued by Chilean treasury.
III.	Corporate bonds	Local high rated corporate bonds. Sub limit of up to 10% of the total of funds by each *Bono Hipotecario* issuance.
IV.	Bonos Hipotecarios	*Bonos Hipotecarios* issued by other banking entities.
V.	Term deposits	Term deposits originated by high rated banks established in Chile, excluding those of the issuer of the covered bonds.
VI.	LCH	Housing LH: *Letras De Crédito Hipotecario* issued for housing purposes by other banking entities.
VII.	Unsecured bank bonds	Unsecured bank bonds rated AA+ or higher, excluding those of own issuance.

Source: Chilean Central Bank, Banco Santander Chile

IV. VALUATION AND LTV CRITERIA

Eligible loans are only accepted as collateral for the corresponding issued bond once the accredited third-party property appraiser has finished the valuation process and, after it has been registered at the corresponding CBR (*Conservador de Bienes Raices*) – the local entities that certify legal dominion of properties.

The minimum loan-to-value (LTV) defined by law is 80%. Conditions for valuation are also subject to performing or non-performing status of loans. The maximum accepted number of arrears of any single loan in the pool is 10. Above that, the loan must be replaced with a new one of the same nature. As explained before for the cover-to-bond outstanding balance ratio all amounts in arrears are excluded.

LTV alone is not enough for eligibility of mortgage loans. In addition a maximum debt-to-income ratio of 25% is demanded.

V. ASSET - LIABILITY MANAGEMENT

Current legislation does not prescribe over collateralization for the issuance of BHs.

Under a balance principle the nominal amount of cover assets must always be at least equal to the outstanding amount of related *Bonos Hipotecarios* and loans in arrears or prepaid should be replaced always under the restriction that only new mortgages are potentially eligible as collateral for BHs.

Banks are free to structure the BHs according to their own needs and criteria. Banco Santander's first issuance is a 15 year amortizing structure reflecting the expected amortization schedule of the underlying loan portfolio adjusted by the empirical loan prepayment rate.

VI. TRANSPARENCY

Current regulation includes a prudential approach associated with financial stability objectives: mandatory monthly reports of assets and liabilities in the Register and compliance of required ratios; a specific Credit Policy for mortgage eligibility which must be approved by the Board of Directors and published on the issuer's webpage; and client's LTV and debt-to-income ratios reported in a monthly basis.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Article 69, n°2 of the LGB mandates banks to maintain a special mortgage register (*Registro de Mutuos Hipotecarios*) for the identification and control of the relation between mortgages and their respective BH issuances.

SBIF's RAN 9.2, n°5, sets conditions for inscription of mortgages on the Register and the required information including: identification of bond issuance and loans; dates of inscriptions; original and substitute loans; identification of fixed income assets held as substitute collateral; and elimination from the register by number of arrears or property value deterioration.

Central Bank's CNF Chapter II.A.2, n°18, within its explicit transparency and information objectives, details monthly reporting data including: up-to-date average debt-to-income ratios of clients with eligible loans for each series of BH issuances; average value of properties linked to BHs at the date the credit was granted; LTV of the pool updated by loan replacements; loan characteristics (maturity, interest rates, fixed, floating or mixed type, currency denomination, inflation link mechanism and loan prepayment conditions); outstanding balances of loan portfolios and associated BH issuances and, finally, the total amount of fixed income assets and its general characteristics

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

There are 2 main issues related with bankruptcy in the BH legislation:

1) Since only new loans are accepted as collateral this avoids the possibility of structuring BHs with a selection of the best quality assets which could be against the interests of other creditors such as depositors in case of bankruptcy.

2) In the case of bankruptcy a special procedure in the way of a separated auction or tender process is triggered for those assets and liabilities clearly identified and associated with BHs in the Register. Eligible bidders are other public or private financial institutions, and the final buyer must take care of BH payments. This process, the same as for Letras de Crédito Hipotecarias (LH) is thoroughly covered in the LGB.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Chile is not a member of the European Union. Therefore, and although Chilean BHs will be issued under the existence of a specific country legislation – which is a requirement for these matters – no special treatment or benefit is expected in terms of preferred risk weighting for regulatory capital purposes.

X. ADDITIONAL INFORMATION

In a clear intent to provide these Bonds with more liquidity the Chilean Central Bank announced on 28 March 2013 a special Repo program ("Repo BH") which will accept exclusively BHs as collateral. The Repo BH will be offered for up to 14 days at a floating rate equivalent to the current monetary policy rate (MPR) of each day plus 25 basis points. Eligible BHs will be subject to the credit rating of the BH issuer banking entity which must be in AAA, AA or A.

3.7 CYPRUS

By Doros Theodorou and Dimitrios Spathakis, Pireaus Bank - Former Network of CPB BANK in Greece

I. FRAMEWORK

Following on to an extensive and fruitful consultation process, which lasted over a year and involved the Central Bank of Cyprus (CBC), the Ministry of Finance, the Cooperative Societies Supervision and Development Authority and the banking industry, Cyprus entered the covered bond universe in December 2010.

The primary legislation governing the issuance of covered bonds (Kalimmena Axiografa) is the Covered Bond Law of 2010, (130 (I)/2010), which came into force on December 23, 2010 (the "Law").

On the same day, the CBC issued a directive (526/2010) under the provisions of the Law, which constitutes the regulatory framework for the issue of covered bonds (the "Directive").

The Law and the Directive (the "Cypriot Legal Framework") are further supplemented by other laws (e.g. the Bankruptcy Law, the Banking Business Law, the Companies Law etc.) as referenced by the Law.

The Cypriot Legal Framework has been finalized in consultation with and following the positive opinion of the ECB, dated 14 October 2010 and 23 March 2011 (related links are: http://www.ecb.int/ecb/legal/pdf/en_con_2011_27_f_sign.pdf and http://www.ecb.int/ecb/legal/pdf/en_con_2010_73__f_sign.pdf)

II. STRUCTURE OF THE ISSUER

Under the Cypriot Legal Framework, Credit Institutions which have been approved by the Competent Authority (i.e. the CBC or the CSSDA), are only allowed to issue covered bonds using the direct issuance route.

Credit Institutions are defined, under the Law, to be:

> Banks (as defined in the Banking Laws);

> Cooperative Credit Institutions (as defined in the Cooperative Societies Law); and

> The Housing Finance Corporation (established under the Housing Finance Corporation Laws).

In accordance with Parts II and III of the Law, only Approved Institutions are eligible to issue covered bonds. Approved Institutions, are those Cypriot Credit Institutions which have been registered in the Register of Approved Institutions, (publicly available at the following link: http://www.centralbank.gov.cy/media/xls/ENG_2_Register_of_Approved_Inst.xls) following a relevant application to the Competent Authority.

Approval of such application is granted within 1 month from submission, and only after the Credit Institution has successfully demonstrated its ability to carry out the legal obligations of an Approved Institution, and that it fulfills the criteria and conditions determined by the Competent Authority.

Indicative minimum requirements set out in the Directive, for the registration of a Credit Institution in the Register of Approved Institutions, are:

> Core Tier 1 capital of at least EUR 50 m and capital adequacy ratio as required by the CBC under Pillar I and Pillar II of the Capital Requirements Directive;

> Establishment of an automated system for the support of the covered bonds business;

> Established risk management procedures for the recognition, management, monitoring and control of risks that may arise during the conduct of the covered bonds business;

> Procedures, policies and systems in place for the support of the covered bonds business; and

> Compliance with the provisions of the Law and the Directive, to be represented by a written confirmation by the Board of Directors of the Credit Institution.

With respect to individual covered bond issuance, Approved Institutions must subsequently apply to the Competent Authority for registration of such new issue in the Covered Bonds Register (publicly available at the following link: http://www.centralbank.gov.cy/media//xls/EN_register_9.04.2012.xls). Approval of such application is granted within 10 days from submission, and it is only following such approval that a newly issued bond becomes a covered bond.

III. COVER ASSETS

Primary cover assets are:

> Residential property backed loans (i.e. any kind of credit facility, secured on immovable property, provided that the property is used or intended to be used for residential purposes;)

> Commercial property backed loans;

> Public claims;

> Maritime loans; and

> Any other type that may be determined by the Competent Authority.

The criteria, terms and conditions in relation to cover assets are determined by the regulator in Art.13, 14 and 15 of the Directive. The main criteria indicatively include:

> Residential and commercial loans should be secured by a mortgage (or an equivalent security over a property if the property is not located in Cyprus) created in accordance with the Laws of Cyprus or the law of other Member States[1];

> The mortgage or the equivalent charge on immovable property, securing the credit facility, is created for an amount, at least, equal to the value of the loan;

> The immovable property securing the credit facility must be situated on the territory of the Republic or on the territory of other Member States;

> A residential or commercial loan secured by buildings under construction may be included in the cover pool, provided that the total value in each cover pool of the loans secured by buildings under construction does not exceed 10% of the cover pool value;

> Rescheduled loans may be included in the cover pool, only after the lapse of six months from the payment date of the first rescheduled loan instalment;

> Hedging contracts may also be included in the cover pool, only to the extent that they are used exclusively for the purpose of hedging any type of risk that may adversely affect the value of the cover assets.

a) It is noted, that in accordance with Art.33(b) of the Directive, the counterparty in a hedging contract must "*have a credit rating assigned to the first credit quality step as determined in Annex VI of the Directive 2006/48/EC or a guarantee by a connected entity of the counterparty whose credit rating is assigned to the first credit quality step*"

Finally, apart for the Primary Cover Assets, Complementary Assets may also be included in the cover pool, as prescribed under Art.16, 17 and 18 of the Directive (e.g. deposits with central banks and other highly rated institutions, traded debt securities, etc.).

1 Member State means a member state of the European Union or other state which is party to the Agreement for the European Economic Area, which was signed in Oporto on 2 May 1992, and adapted by the Protocol signed in Brussels on 17 May 1993

Limitations and guidelines on the above are specified in the Directive (e.g. total value of Complementary Assets included in the cover pool and counted in the measurement of the Basic Collateralisation, not to exceed 15% of the total value of covered bonds, etc.).

IV. VALUATION AND LTV CRITERIA

For **residential loans**, the LTV is not allowed to exceed 75%, provided that if the LTV is above 75% but below 100%, such loans may be included in the cover pool on the condition that:

> They do not exceed 25% of the value of the covered bonds secured by the cover pool; and

> Such inclusion would not cause the weighted LTV of the cover pool to exceed 80%

For **commercial loans**, the LTV is not allowed to exceed 60%, provided that if the LTV is above 60% but below 80%, such loans may be included in the cover pool on the condition that:

> They do not exceed 25% of the value of the covered bonds secured by the cover pool, and

> Such inclusion would not cause the weighted LTV of the cover pool to exceed 65%

For **maritime loans**, the LTV is not allowed to exceed 60%, provided that if the LTV is above 60% but below 70%, such loans may be included in the cover pool on the condition that:

> They do not exceed 25% of the value of the covered bonds secured by the cover pool, and

> Such inclusion would not cause the weighted LTV of the cover pool to exceed 65%

In accordance with Art.13(10) and Art.15(10) of the Directive, the valuation of residential and commercial properties and the valuation of ships (Art.15(10) of the Directive) should be carried out by an independent valuer; i.e. a person who possesses the necessary qualifications, ability and experience to produce a valuation and is independent from the credit decision process.

For the monitoring and review of the value of the residential and commercial properties, the provisions of paragraph 8 (b) of Part 2 of Appendix VIII of the Directive of the Central Bank to banks for the Calculation of the Capital Requirements and Large Exposures shall apply. The provisions of the Directive dictate the following:

> The revaluations of the properties may be carried out by applying statistical methodologies.

  a) For commercial properties, according to the aforementioned Directive, the value of the property is reviewed regularly and at least once a year;

  b) For residential properties, according to the aforementioned Directive, the value of the property is reviewed regularly and at least once every three years; and

  c) In situations where the market is subject to significant changes in conditions, a more frequent review of the property value is required.

> When information indicates that the value of the property may have declined materially relative to general market prices, the property valuation must be reviewed by an independent valuer

> Also when the balance of the financing exceeds €3million or 5% of the own funds of the credit institution, the valuation of the property will be reviewed by an independent valuer at least every 3 years

Additionally, and pursuant to Art.46(b) of the Directive, the Covered Bond Monitor ("CBM"), appointed in accordance with Art.49 of the Law, has a duty to examine the valuation process in relation to the valuation of the cover assets.

V. ASSETS - LIABILITY MANAGEMENT

The Directive provides for the following statutory tests:

> **Nominal Value Test**

The adjusted[2] nominal value[3] of the Basic Cover (i.e. the Basic Collateralisation as defined under Art.24 of the Directive) must be at least equal to the total value of covered bonds issued under the programme.

> **Net Present Value Test**

The adjusted net present value of the Basic Cover must be at least equal to 105% of the total net present value of covered bonds issued under the programme. All cover pool assets, including loans, Complementary Assets and hedging instruments must be included in the calculation of net present value of the Basic Cover.

The above 105% condition must also be met in the following scenarios:

a) Parallel interest rate shift of +200 and -200 basis points;

b) Interest rate shifts determined by a 99% 6-month confidence interval using daily changes for the last 365 days;

c) Exchange rate changes:

> Euro and member-state currencies: 10%;

> Currencies of the United States, Canada, Japan, Switzerland, Australia: 15%; and

> Other currencies: 25%.

d) Exchange rate shifts determined by a 99% 6-month confidence interval using daily changes for the last 365 days.

> **Weighted Average Life Test**

The weighted average life of cover assets counted in the measurement of Basic Cover and Supervisory Overcollateralisation (as defined under Art.25 of the Directive), must be longer than the weighted average life of the covered bonds.

> **Interest Cover Test**

Interest inflows from cover pool assets in the Basic Cover and Supervisory Overcollateralisation for the next 180 days must be reconciled with interest due on the covered bonds for the next 180 days and the highest net interest shortfall must be covered by the Complementary Assets contained in the Basic Cover and Supervisory Overcollateralisation.

> **Prematurity Test**

In relation to the repayment of the principal amount of the covered bonds, liquidity must be maintained, in the form of Complementary Assets or outside the cover pool in the form of liquid assets, as follows:

a) For the period between 180 days to 30 days before the maturity date of the covered bonds, at least 50% of the principal amount due for repayment;

b) For the period between 30 days before the maturity date and the maturity date of the covered bonds, 100% of the principal amount due for repayment.

2 Adjusted, refers to the set-off and LTV adjustments, as outlined under Art.24 of the Directive

3 "Value" is defined under the Directive to mean nominal value plus accrued interest

Liquidity maintained for the purpose of meeting the prematurity test is not subject to the 15% limit of Complementary Assets in the cover pool (set in Art.20 of the Directive).

Additionally to the above statutory tests, and with a view to protect the depositors and all other unsecured creditors in case of insolvency proceedings, and to potentially provide for a reserve of assets that may be used in the future to sustain further stresses, the Directive provides that an Approved Institution is not permitted to issue covered bonds, if such an issue would result in:

> the total value of the primary assets which are required to be included in the institution's cover pools for each cover bond category, to exceed 90% of total value of the institution's eligible primary assets for that cover bond category, or

> the total value of the cover assets included in all cover pools and counted in the cover pool adequacy, to exceed 25% of the total value of the institution's assets.

VI. TRANSPARENCY

Transparency, in the Cypriot Legal Framework, is ensured through a series of reporting and registers that need to be maintained, updated and monitored by the covered bond Issuers as well as by the Competent Authority.

In accordance with Art.23 of the Law, covered bond Issuers are required to maintain a cover pool register for each covered bond Issue or Programme outstanding. Specific conditions for maintaining such Cover Pool Register (e.g. form, content, entry recording etc.) are outlined in Art.34-38 of the Directive. The Cover Pool Register is to be updated whenever an asset is included or excluded from the cover pool (and at least on a monthly basis) and shared with the Competent Authority and the CBM.

Specifically, Art.39-42 of the Directive set further transparency obligations to the covered bond issuers, requiring them to disclose, on a quarterly basis and in a publicly accessible area (e.g. their websites), specific statistical information relating to their outstanding covered bonds, in the form determined therein. The above information is also submitted to the Competent Authority and the CBM on a quarterly basis, in the form of Appendix 5 of the Directive.

With respect to the covered bond issuers and the covered bonds issued and outstanding in Cyprus, transparency is ensured through the maintenance of a Register of Approved Institutions (Art.5 of the Law) as a well as a Covered Bonds Register (Art.12 Law) by the Competent Authority. Both registers are kept in an electronic form and are publicly accessible in the website of the Competent Authority.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The Cypriot Legal Framework is structured in a manner which ensures very vigilant regulatory supervision of covered bond issuers. In accordance with Art.49 of the Law, each institution applying for registration in the Register of Approved Institutions, is required to appoint a qualified entity (e.g. an audit firm not associated with the covered bond issuer) as a Covered Bond Monitor (the "CBM"), such appointment being subject to the approval of the Competent Authority. The CBM must possess the necessary knowledge, experience and ability for the effective discharge of its functions and have the necessary qualifications outlined in Art.44 of the Directive. To the extent that, for any reason, the covered bond issuer has not managed to appoint a CBM, the Competent Authority is entitled to appoint one.

The duties of the CBM include a broad range of responsibilities, ranging from verifying to the Competent Authority, ahead of the application for the registration of bonds in the Covered Bonds Register, that the institution fulfils the conditions for registration as an approved institution, to submitting information and regular reports to the Competent Authority.

The main responsibilities of the CBM under the Cypriot Legal Framework, include:

> Overseeing the compliance of the Issuer with its obligations under the Cypriot covered bond Legislation;

> Prior to an application for the registration of any covered bonds in the Covered Bonds Register, verifying that the Issuer fulfils the conditions for registration as an approved institution and complies with the provisions of the Law in relation to every previous issue of covered bonds that are outstanding

> Where hedging contracts are included in a cover pool, verifying that these contracts fulfil the criteria set out in Art.26 of the Cypriot covered bond Legislation;

> Monitoring the cover pool assets included in a cover pool, including:

a) Verifying the accuracy and completeness of the information provided for the cover pool Assets included in the Cover Pool Register;

b) Examining the valuation process in relation to the valuation of the cover pool assets;

c) Monitoring compliance, on an on-going basis, with the Statutory Tests; and

d) Examining the entries in and removals from the Cover Pool Register and confirming the correct recording of the necessary information in the Cover Pool Register

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

Following the registration of the covered bonds in the Covered Bonds Register, and in accordance with Art.16 of the Law, the cover pool is segregated from the covered bond issuer's insolvency estate, securing the claims of the Cover Pool Creditors[4] and constituting a form of charge over the cover pool assets.

In accordance with the provisions of Art.28 of the Law and Art.21 of the Directive, covered bond issuers are required to maintain a Special Transaction Account, recording all inflows from the cover assets and the outflows from the account together with the details of such outflow. The balance of such Special Transaction Account is to be used solely for the servicing of the covered bonds as well as for the creation or acquisition of cover assets to be included in the cover pool, to ensure fulfillment of the cover pool adequacy criteria.

Furthermore, pursuant to Art.21(3) of the Directive, the covered bond issuer must have procedures in place which ensure, at any time, the ability to trace and calculate the cash inflows from the cover assets that have not been used. The operation of the Special Transaction Account is subject to the supervision of the CBM, in order to ensure that the covered bond issuer complies with the provisions of the Cypriot Legal Framework at all times.

In case of dissolution of the covered bond issuer, and until all legal claims of the Cover Pool Creditors are fully satisfied, the cover pool assets are not available to satisfy the claims of any other creditors of the Issuer in accordance with Art.40(5) of the Law.

By virtue of Art.40(7), 41 and 42 of the Law, the Covered Bond Business Administrator (the "CBBA") is empowered to dispose of the Cover Pool Assets, and use the proceeds of such disposal in order to satisfy the claims of the Cover Pool Creditors in priority over the claims of all other creditors.

To the extent that a covered bond issuer is subject to dissolution proceedings, in accordance with Art.40(5) and Art.40(6) of the Law, until the claims of the Cover Pool Creditors are satisfied in full, the cover pool assets will not be available to satisfy the claims of other creditors. Any surplus from the disposal of the cover pool, and only once the claims of the Cover Pool Creditors have been satisfied in full, shall be returned to the credit institution (Art. 44(1) of the Law).

4 Cover Pool Creditors are defined in Art.2 of the Law to include, inter alia, the Covered Bond holders, the hedge counterparties, the Covered Bond Monitor and the Covered Bond Business Administrator

Cover Pool Creditors enjoy a dual recourse, safeguarded under the Law. In accordance with Art.43(5) of the Law, to the extent that the claims of the Cover Pool Creditors are not fully satisfied from the disposal of the cover pool, then these creditors are, with respect to the unsatisfied part of their claims, unsecured creditors of the covered bond issuer.

In addition, where a covered bond Issuer is subject to dissolution proceedings, a Covered Bond Business Administrator (CBBA) is appointed by the Competent Authority (as per Art.59(1) of the Law), who takes all necessary measures to assume the control and the management of the cover pool and carries out the covered bond business. Any Cover assets not counted for the purposes of fulfilling the Statutory Tests shall be removed from the cover pool and the Cover Pool Register only by the CBBA.

The treatment of the cover pool following the commencement of dissolution proceedings is summarized below:

> Upon the initiation of dissolution proceedings, the CBBA assumes control of the cover pool (*according to the provisions of Art.40 of the Law*) and also of any liquid assets maintained outside the Register for the purposes of meeting the Prematurity Test, and is responsible to review the adequacy of the cover pool in accordance with Art.19 and Art.23 of the Directive;

> Cover pool adequacy assessment is being performed by the CBBA as per Art.18(6) of the Law, using solely those cover assets which are counted for the purposes of such assessment;

> To the extent that the above assessment has been successfully met, any assets which are not required to meet such assessment, including relevant requirements under a contractual OC, are being released and become available to satisfy the claims of all other creditors, members and investors of the credit institution;

> To the extent that the above assessment has not been successfully met, the CBBA (*according to the provisions of Art.29(2) of the Directive*) is entitled to use any assets included in the cover pool register that do not meet the criteria, terms and conditions for counting a cover asset in the cover pool adequacy. (*To the extent that such assessment is not met, the CBBA has the right to accelerate or transfer the CB business to another approved institution, in accordance with Art.62(1) of the Law*).

With respect to an automatic acceleration of the covered bonds, this is something that is not provided for by the Law, where a covered bond Issuer is subject to dissolution proceedings.

In accordance with Art.40(1) of the Law, all outstanding covered bonds will remain in force (subject to the terms and conditions under which they were issued), and the obligations of the covered bond Issuer under the covered bonds continue to be enforceable.

IX. RISK WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Cypriot covered bonds meet the criteria of UCITS 52(4) and also qualify under the CRD Directive, resulting in a 10% risk weighting assigned by the CBC. covered bonds issued under the Cypriot Legal Framework form acceptable collateral for refinancing purposes with the ECB, following the typical ECB eligibility assessment and their inclusion on the ECB Eligible Assets Database (EADB).

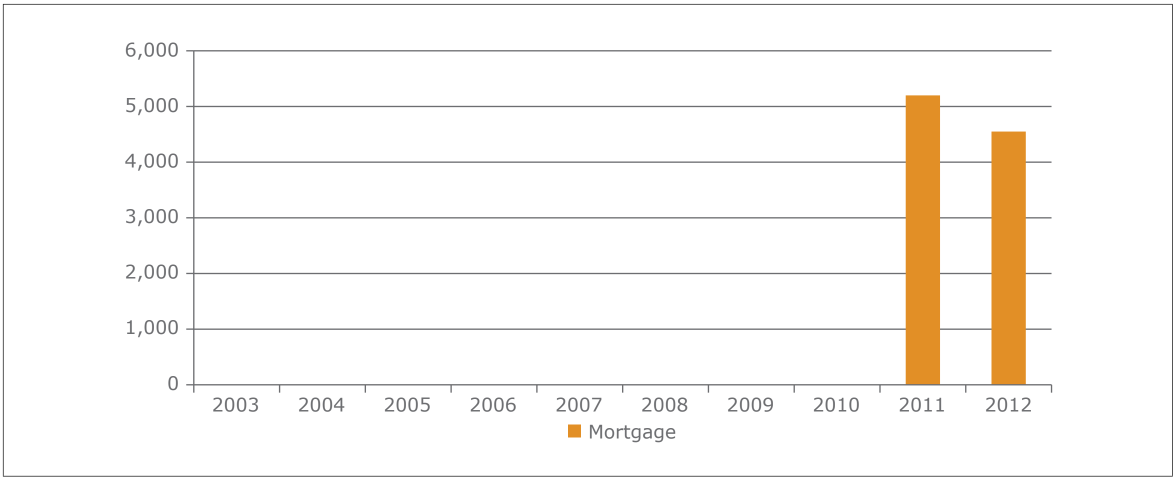
X. ADDITIONAL INFORMATION

Covered bond issuers are, in accordance with Art.20 of the Law, required to maintain, throughout the life of the covered bonds, a set-off reserve in connection with cover assets that are subject to set-off.

The Directive provides for the maintenance of such a set-off reserve, in the form of additional assets which are included in the cover pool (Art.22, 24 and 25 of the Directive).

The set-off reserve is quantified by the Issuer and such calculation is subject to the monitoring of the CBM. The set-off reserve is segregated from the Issuer's other assets, forming part of the cover pool where Cover Pool Creditors have a priority claim over amounts in such reserve.

> Figure 1: Covered Bonds Outstanding, 2003-2012, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2012, EUR m

Source: EMF/ECBC

Issuers: There are two issuers in Cyprus: Cyprus Popular Bank Public Co Ltd and Bank of Cyprus Public Co Ltd.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/93/Cypriot_Covered_Bonds

3.8 CZECH REPUBLIC

By Libor Ondřich, UniCredit Bank Czech Republic

I. FRAMEWORK

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

At present, the MCBs, the mortgage loans (hereinafter also referred to as "ML") and the other terms and conditions of mortgage financing are regulated in detail in the Bond Act (hereinafter also referred to as "BA"), which entered into force on April 1, 2004. The latest amendment has been effective since August 1, 2012, which, besides other things, enables issuance of the MCBs under a law different from the Czech law and clarifies the calculation of the minimum LTV required by the law.

Specific provisions treating cover assets and applicable at the opening of the insolvency proceedings or declaration of bankruptcy of the issuing bank are part of the Insolvency Act No. 182/2006 Coll.

II. STRUCTURE OF THE ISSUER

MCBs may only be issued by a bank holding a Czech banking license (i.e., a banking license issued under the Banking Act no. 21/1992) and having its registered office in the Czech Republic (an "Issuing Bank"). An Issuing Bank can generally pursue all business activities that are permitted for credit institutions and need not be a specialized bank. The MCBs constitute direct and unconditional obligations of the Issuing Bank, and the Issuing Bank is fully liable for any payment obligations thereunder. All obligations arising from the MCBs are obligations of the Issuing Bank as a whole to be paid from all the assets of the Issuing Bank, subject to specific provisions applicable to the Issuing Bank's insolvency (dual recourse).

III. COVER ASSETS

Pursuant to the BA, the MCBs are such covered notes where the nominal value of and revenue from which are fully covered with (i) receivables from MLs or parts of these receivables (the so-called "regular coverage") and (ii) by substitute collateral. The text "Mortgage Covered Bond" has to be a part of the name of this covered bond. No other securities and/or covered bonds are allowed to use this name.

ML is such loan that is secured with a mortgage to a real estate (residential mortgages, commercial mortgages, land, buildings under construction). The amount of receivables from ML must not exceed double the collateral value of the mortgaged real estate. The real estate under the mortgage right has to be located on the territory of the Czech Republic, a member state of the European Union or another country making a part of the European Economic Area. The loan is considered to be the mortgage loan on the day of origin of legal effects of the mortgage right registration.

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

> Is extended by a building society or a loan extended for a cooperative housing construction supported by the State. The precondition for this is that the building society or the creditor of the cooperative housing construction loan that have the priority sequence of the mortgage right have given a written consent to the issuer of MCBs to establish the mortgage right in a lower ranking. The receivable from the ML secured with a mortgage right not in the first position may not be used to cover the MCBs without such consent.

> Will be repaid so that the mortgage right related to the ML will move from the second position to the first position of registration in the Real Estate Register.

Substitutive Coverage

Substitute collateral is restricted to 10% of the nominal amount of MCBs outstanding. The following substitute assets are eligible:

> Cash;

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

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

> Government bonds and/or securities issued by the CNB;

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

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

IV. VALUATION AND LTV CRITERIA

Only the issuer's receivables arising from mortgage loans or parts thereof may be used for the proper coverage of the total obligations arising from all the mortgage bonds in circulation issued by one issuer. Such receivables or parts thereof may not, during the period when they are used for such coverage, exceed 70% of the aggregate mortgage lending value of the mortgaged property securing such receivables (70% portfolio LTV limit).

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

The issuer of the MCBs determines the *mortgage lending value* of the real estate under mortgage, and namely as the prudent market value, taking into consideration:

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

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

> The rights and defects associated with the real estate; and

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

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

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

V. ASSET – LIABILITY MANAGEMENT

The sum of all the liabilities from all the MCBs in circulation issued by one issuer has to be fully covered with the receivables or their parts from the ML (regular coverage) or possibly in a substitutive manner (substitutive coverage). No other test is required by the law. Derivatives are not eligible cover assets.

VI. TRANSPARENCY

An initiative sponsored and coordinated by the Czech Banking Association aiming for the improvement of the covered bond legislation was launched in December 2012. The initiative prepares proposals for legislative changes, which should help to further promote soundness of the Czech covered bond market. The Bond Act and Insolvency Act are within the scope of this initiative.

VII. COVER POOL MONITORING AND BANKING SUPERVISION

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

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

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

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

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

In the event of bankruptcy or bankruptcy proceedings of the issuer of the MCBs, the receivables from the MCBs in circulation issued by it have a priority rank for satisfaction. The assets (the receivables from the ML) serving to cover the MCBs of the bankrupt issuer constitute the mortgage estate (cover pool). A special administrator may be appointed to administer the mortgage estate and to satisfy the claims resulting from the MCBs in circulation. The yield from the encashment of the mortgage estate shall be first used to satisfy the costs of administration and encashment of the mortgage estate and then immediately to satisfy the receivables of the MCBs without limitation of their amount. Only the rest shall be used to satisfy the other receivables from the bankrupt issuer. Otherwise there is no specific provision regarding the treatment of cash flows generally, including those received prior to opening of the insolvency proceedings or declaration of bankruptcy and those received afterwards. The current automatic acceleration of covered bonds is intended to be removed in the planned update of the legal framework for Czech covered bonds.

IX. RISK WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The risk weighting of MCBs is regulated by the Czech National Bank decree no. 123/2007 Coll. transposing EU's Capital Requirements Directive into the Czech law. Risk weight of 10% (under the standardized approach) is assigned provided that the MCB complies with the requirements of the Annex 4 of the afored mentioned decree.

Czech investment legislation allows investment funds to invest up to 25% of the fund's assets in MCBs complying with the requirements of Art. 52 par. 4 UCITS Directive (Art. 28 par. 2(c) of the Czech Collective Investment Act).

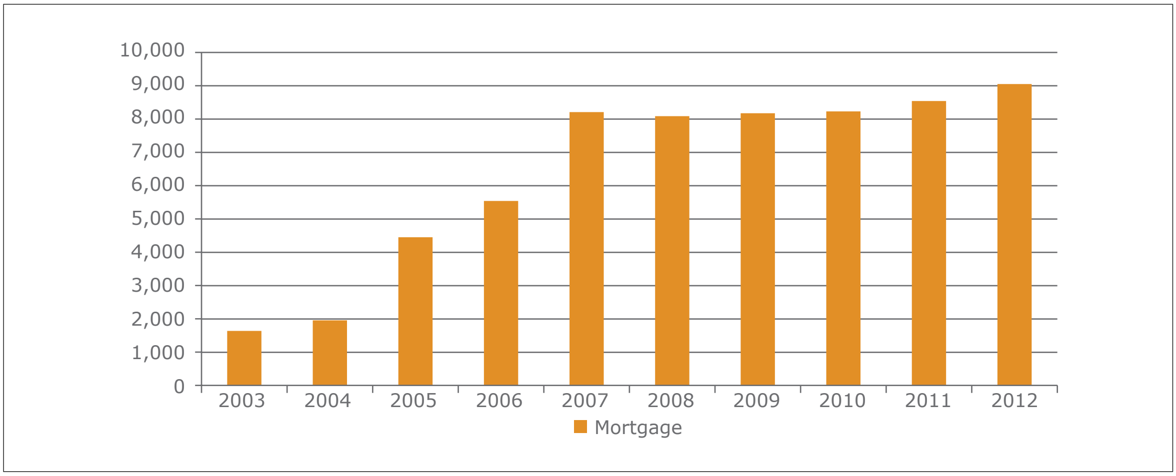
X. ADDITIONAL INFORMATION

State Incentives

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

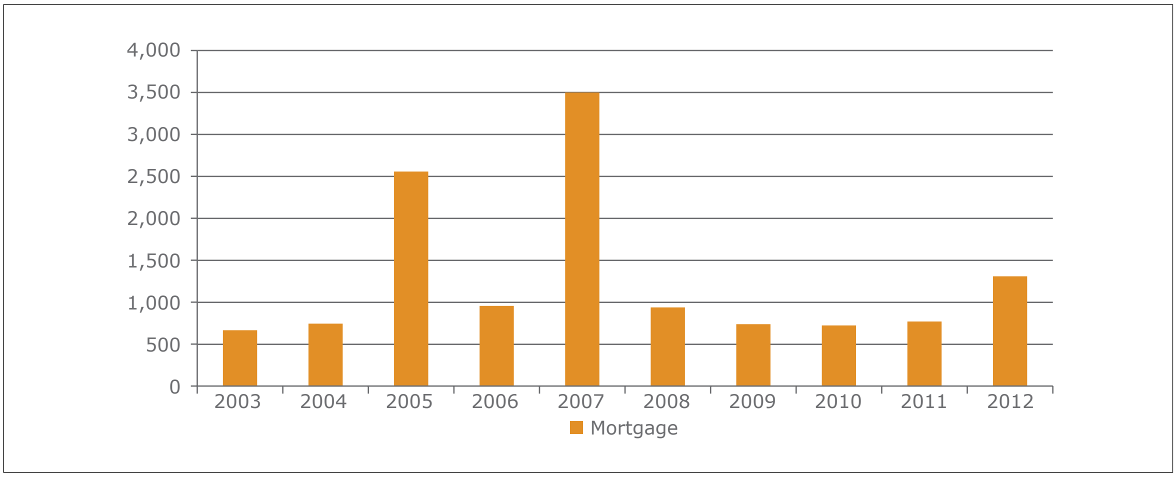
The interest revenues from MCBs are exempt from the income tax, provided that such MCBs were issued before the 1st of January, 2008 and are covered by receivables from MLs for housing investments.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2012, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2012, EUR M



Source: EMF/ECBC

3.9 DENMARK

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

I. FRAMEWORK

The Danish Act on covered bonds (SDOs) came into force on 1 July 2007. It was passed to implement the new set of rules on covered bonds from the EU (capital requirements directive - CRD I). At the same time, it met the political objective of giving both mortgage banks and commercial banks the opportunity to issue SDOs.

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

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

II. STRUCTURE OF THE ISSUER

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

Until 1 July 2007, only mortgage banks were allowed to issue mortgage bonds/covered bonds. Since this date, also commercial banks can obtain a license to issue covered bonds. This leads to the existence of three types of Danish mortgage bonds:

> The (traditional) mortgage bonds (*Realkreditobligationer*, ROs) issued exclusively by mortgage banks. ROs are UCITS compliant (article 52(4)).

> The (new) covered mortgage bonds (*Særligt Dækkede Realkreditobligationer*, SDROs) issued exclusively by mortgage banks, fulfilling the former as well as the new legal requirements. SDROs are both UCITS (article 52(4)) and CRD compliant (Annex VI, 68).

> The (new) covered bonds issued by either commercial or mortgage banks (*Særligt Dækkede Obligationer*, SDOs). SDOs are both UCITS (article 52(4)) and CRD compliant (Annex VI, 68).

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

The covered bond legislation in Denmark allows for joint funding, i.e. two or more institutions joining forces to issue covered bonds in order to achieve larger issues. The first issue of joint funding between non-affiliated institutions took place in 2012.

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

The specialist banking principle implies that mortgage banks are confined to granting loans that meet the requirements for cover assets imposed by legislation. Similarly, the funding sources are limited to ROs, SDOs

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

and SDROs. This is due to the fact that Danish mortgage banks are not allowed to accept deposits, etc. as a source of funding, cf section 8 of the Financial Business Act.

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

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

III. COVER ASSETS

Assets eligible as the basis for bond issuance:

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

To serve as cover assets, mortgages must be entered in the Danish land register, which is kept by the Danish district courts. Land and loan registration has been digital since 2009 with faster and more efficient handling of customers' loans as a result.

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

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

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

IV. VALUATION AND LTV CRITERIA

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

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

LTV limits - an overview

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

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

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

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

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

V. ASSET - LIABILITY MANAGEMENT

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

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

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

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

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

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

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

> Provision of liquidity for actual disbursement;

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

> Balance of future payments on capital centre level.

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

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

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

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

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

VI. TRANSPARENCY

A high level of transparency has always been an important characteristic of the Danish covered bond market. The Danish covered bond issuers publish information via many different platforms, such as prospectuses, investor reports, trading venues and issuers' investor relations web sites.

Transparency has always been a priority for Danish covered bond issuers and information is easily accessible. Until now, however, the information has been somewhat fragmented, requiring investors to seek and collect information from different sources and in different formats.

To complement the ECBC Label Initiative the Danish market participants have gathered available information and consolidated it in an intuitive and user-friendly structure in the national transparency template. With the national transparency template investors are offered a single point of entry for the extensive available information on covered bond issues – be it SDO, SDRO or RO. The transparency template helps investors obtain an extensive overview of a covered bond issue at a minimum effort.

The establisment of the national transparency template provides the investors with means to compare key information across an array of issuers. The transparency template makes it easier for new investors to get an overview of covered bonds available for investment and is a valuable tool which support covered bond investors' investment decisions.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

> A trustee will be appointed by the bankruptcy court to administer all financial transactions of the issuer;
> The trustee will be instructed to meet all payment obligations under bonds issued in due time despite any suspension of payments of the issuer;
> All new lending activities of the issuer will be suspended;
> The trustee may issue bonds to refinance maturing bonds and raise secured loans to obtain liquidity (cf below);
> The trustee may transfer an entire capital centre to another mortgage bank;
> Payments on loans will not be accelerated, and therefore payments from borrowers will fall due according to the original payment schedule;
> The trustee will not meet the claims of other creditors until all payment obligations under the senior bonds have been met in full; and
> Derivative counterparties enjoy the same legal position as senior bonds.

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

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

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

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

Commercial bank registers

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

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

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

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

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

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

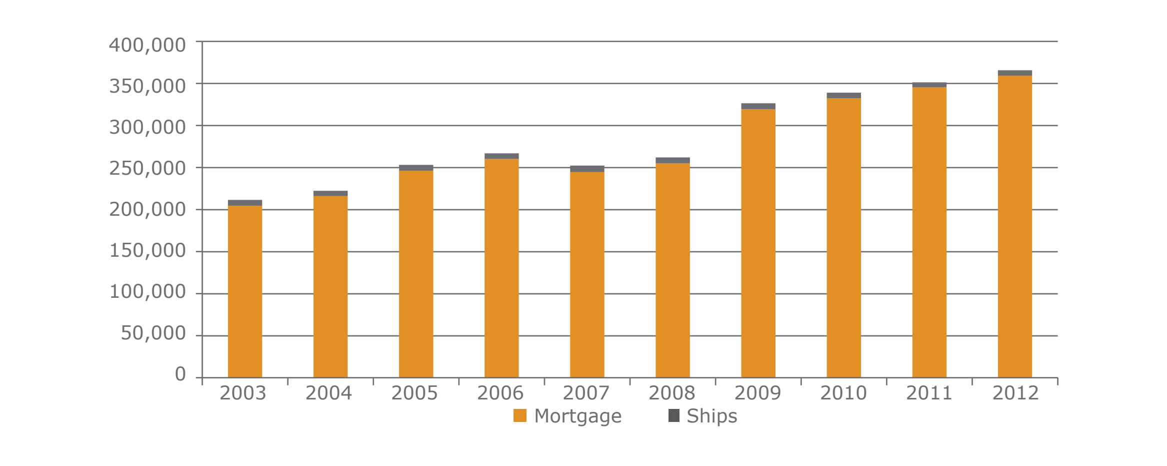
IX. RISK WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

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

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

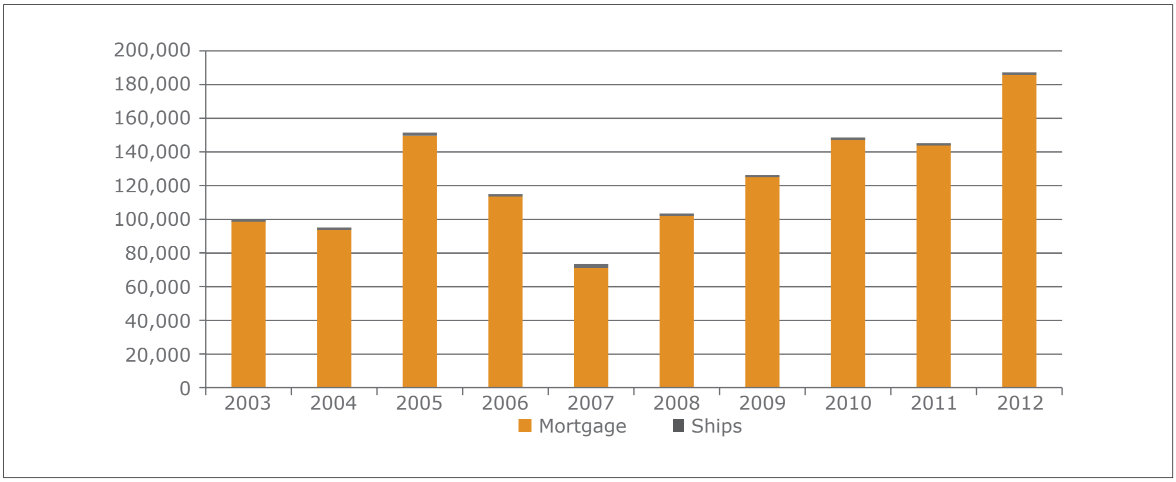
In the Danish legislation on large exposure limits in credit institutions a 100 % exemption is given to SDO’s and SDRO’s. Exemptions for RO’s issued after 31 December 2007 are either a 50 % (residential loans) or 25 % (commercial loans).

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2012, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2012, EUR M



Source: EMF/ECBC

Issuers: Covered Bonds backed by real estate collateral are primarily issued by the specialised mortgage banks: BRFkredit a/s, DLR Kredit A/S, LR Realkredit A/S, Nordea Kredit Realkreditaktieselskab, Nykredit Realkredit A/S (incl. Totalkredit A/S) and Realkredit Danmark A/S. FIH Realkredit A/S ceased new lending and issuance in 2004. At the end of 2012 the mortgage banks' outstanding volume of covered bonds was EUR 338 bn. Since the current Danish regulation on Covered Bonds entered into force on 1 July 2007, only one commercial bank, Danske Bank A/S, has utilised the possibility to issue covered bonds. Danske Bank has issued non-pass-through (euro-style) covered bonds of a value of around EUR 21 bn. Danish Ship Finance is the only Danish issuer of Covered Bonds backed by ship loans.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/87/S%C3%A6rligt_D%C3%A6kkede_Obligationer_-_SDO, http://ecbc.eu/framework/88/S%C3%A6rligt_D%C3%A6kkede_Realkreditobligationer_-_SDRO and http://ecbc.eu/framework/89/Realkreditobligationer_-_RO

3.10 FINLAND

By Timo Ruotsalainen, Aktia Real Estate Mortgage Bank
and Bernd Volk, Deutsche Bank

I. FRAMEWORK

In Finland, the legal basis for covered bond issuance is the Act on Mortgage Credit Bank Operations (HE 42/2010). The new legal framework replaced the old Act on Mortgage Credit Bank (1999) and entered into force on 1 August 2010. The new law overruled the special banking principle and gathered all Mortgage Credit Bank related legislation under same act. Besides, other technical changes, e.g. mixed pools, have been allowed.

The provisions of the new legal framework do not apply to covered bonds issued or derivatives contracts registered before the entering into force of the new act. No counterparty restrictions apply and derivative counterparties are typically internal.

II. STRUCTURE OF THE ISSUER

The issuer of Finnish covered bonds can be a universal bank or a specialist mortgage bank. Generally, entities that can issue covered bonds are credit institutions authorised to engage in mortgage credit bank operations. The issuer of Finnish Covered Bonds can still be a specialised bank, but deposit banks or credit entities are entitled to apply for a licence to issue covered bonds. The existing specialised banks tend to stay in business in the way they have been operating since being established. Unless it is a mortgage credit bank, the issuer must obtain a license to engage in mortgage credit bank operations (i.e., issue covered bonds).

The Finnish covered bond law stipulates certain requirements to receive a covered bond issuance license. The covered bond issuer should provide a business plan, show financial stability, expertise in mortgage credit operations, risk management and practices concerning valuation of collateral. Interestingly, the requirements to receive a Finnish covered bond license seem very similar to the requirements to receive a German Pffandbrief license.

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

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

III. COVER ASSETS

Finnish covered bonds have a cover pool register that includes all cover pool assets, covered bonds and derivatives. Eligible assets for Finnish covered bonds are residential mortgage loans (including shares in Finnish housing companies), commercial mortgage loans, public sector loans and substitution assets. At least 90% of the cover pool loans must consist of residential mortgage loans, public-sector loans or substitution assets. Cover pool assets can be within European Economic Area countries.

Enforcement of non-Finnish cover pool assets would usually be determined by the laws of the jurisdiction in which the assets. Due to European law, inside the EU, enforcement is safeguarded anyway. However, Finnish issuers have so far only Finnish assets in the covered bond pools.

Derivatives may also be registered in the cover pool. The geographical scope of cover assets is restricted to the European Economic Area (EEA). Residential mortgage loans, shares in housing companies as well as commercial mortgage loans up to 10% of the total pool are eligible as cover assets.

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

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

Up to 20% of the mortgage cover pool is allowed to consist of substitute cover assets; bonds and other debt obligations issued by the State, a municipality or another public-sector organisation or another credit institution than one belonging to the same consolidation group as the issuer; a guarantee as for own debt granted by a public-sector organisation or credit institution referred above; a credit insurance given by an insurance company other than one belonging to the same group, referred to in the Act on Supervision of Finance and Insurance Groups; cash assets of the issuer deposited in the Bank of Finland or a deposit bank with the restriction that if the issuer is a deposit bank the cash deposit may not be in a deposit bank belonging to the same consolidation group as the issuer.

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

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

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

IV. VALUATION AND LTV CRITERIA

The property valuation within the legal framework for covered bonds in Finland is based on market values, valuations are based on "current value", market value determined in accordance with FFSA regulations. Based on the updated regulation, the issuer needs to monitor the valuation of the property also based on statistical methods (indexed value) quarterly and set limits for the acceptable changes of the values. Should the value exceed or drop below the limits the property valuation needs to be updated accordingly.

There are different LTV levels for residential and commercial mortgage loans: 70% of the value of the residential property and 60% of the value of the commercial property accepted. This LTV is a relative limit, i.e. when a loan exceeds the 60%/70% limit, the part of the loan up to 60%/70% LTV remains eligible to the cover pool. A loan placed as collateral for a covered bond may not exceed the current value of the property standing as collateral.

V. ASSET - LIABILITY MANAGEMENT

There are legal standards for Asset-Liability Matching in the Finnish Covered Bond System. For instance, the aggregate interest received on the cover assets in any 12-month period must exceed the interest paid on the outstanding covered bonds. This regulation takes derivatives for hedging purposes into account.

The total amount of collateral of covered bonds shall continuously exceed the remaining combined capital of the covered bonds.

The net present value of the total amount of collateral of covered bonds shall continuously exceed by at least 2% the total net present value of the payment liabilities resulting from the covered bonds. The net present value test helps mitigate interest-rate, currency and liquidity risk.

As mentioned above, interest receivable on cover assets must be sufficient to cover interest payable on covered bonds on a twelve month rolling basis. Moreover, the test needs to be stressed by +/- 1%. In case of a breach of one of these rules mentioned, the issuer might face sanctions from the FSA. Ultimately, the issuer might face the loss if its licence. In addition to the 2% net present value legal minimum, further OC may be committed by contract. Non-performing loans (defined as 90 days past due) are excluded from cover tests. Assets that are ineligible for Finnish covered bonds (.e.g. non-performing loans) are excluded from the cover tests, but can be retained in the cover pool and lead to additional OC.

VI. TRANSPARENCY

The annual and interim reports of the issuer indicates, in addition to that provided in the act on Credit Institutions, the basis of the valuation of the collateral and the amount of residential mortgage loans and possible intermediary loans and public sector loans issuer has granted, as well as the amount of covered bonds issued.

The leading Finnish issuers have adopted the ECBC Label initiative for Covered Bonds and created Finnish National Transparency Template: https://www.coveredbondlabel.com/issuers/national-information-detail/9/.

On top of the regulatory requirements all issuers provide additional information about the cover pools, ratings and other relevant topics on their websites. Please find the website information at section X, Additional information.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The issuer carries out the monitoring of the cover pool. Therefore, the issuer reports to the FSA on a monthly basis. With regard to UCITS 52(4), this supervision of a specialised bank as issuer of the covered bond is compliant to the "special supervision". The FSA has the legal power to take appropriate measures. It is allowed to conduct inspections at the bank in question or to require documents. Also, the FSA could issue a public warning or admonition. Ultimately, it is up to the FSA to revoke the banking licence of the bank in question.

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

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

The cover register contains information about the principle amount of covered bonds issued, the mortgages and substitute assets covering these bonds as well as derivative transactions hedging these bonds or funds placed as their collateral. The Finnish covered bond law specifically excludes set-off against cover pool assets. The law also specifically excludes claw-back risk.

Asset segregation

The cover pool is a part of the general estate of the bank as long as the issuer is solvent. If the insolvency proceedings are opened, by operation of law, the assets recorded in the cover registers are excluded from the general insolvency's estate. When the insolvency proceedings are opened, the FSA appoints a special cover pool administrator. Within the insolvency procedure, the derivative counterparties rank pari passu to covered bond holders. The cover assets do form a separate legal estate, which is ring-fenced by law from other assets of the issuer.

Impact of insolvency proceedings on covered bonds and derivatives

Covered bonds do not automatically accelerate when the issuing institution becomes insolvent. The legal consequences for the derivatives in case of an insolvency of the issuing bank depend on the relevant contracts. The cover pool administrator can only accelerate the covered bonds if the cover tests can no longer be fulfilled. This would trigger the sale of the cover pool assets.

Preferential treatment of covered bond holders

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

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

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

Access to liquidity in case of insolvency

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

Up to 20% of the cover pool may consist of liquid substitute cover assets. Substitute assets are deposits, bonds or guarantees of public sector entities or credit institutions and certain credit insurance. With the consent of the FSA, this limit may even be higher. As all cover assets entered into the cover register are ring-fenced in case of an insolvency of the issuer, this results also in the insolvency remoteness of voluntary over-collateralisation.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Finnish Covered Bonds comply with the requirements of Art. 52(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.

X. ADDITIONAL INFORMATION

Websites of Finnish Issuers:

Aktia Real Estate Mortgage Bank

> http://www.aktia.fi/aktia_real_estate_mortgage_bank

Danske Bank

> http://www.danskebank.com/en-uk/ir/Debt/Pages/Debt.aspx

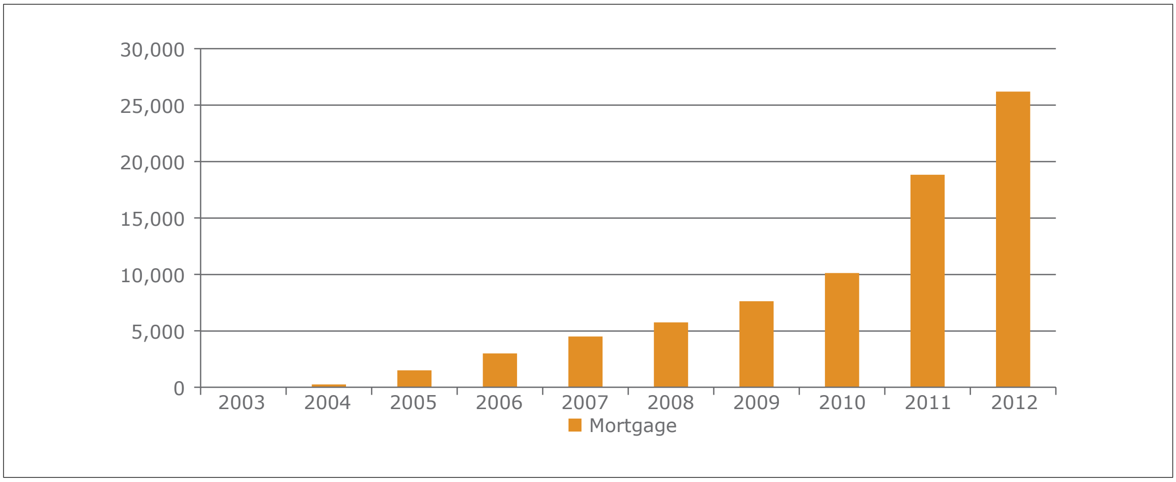
Nordea Bank Finland

> http://www.nordea.com/Investor+Relations/Debt+rating/Nordea+Bank+Finland/Cover+pool+data/1439622.html

OP Mortgage Bank

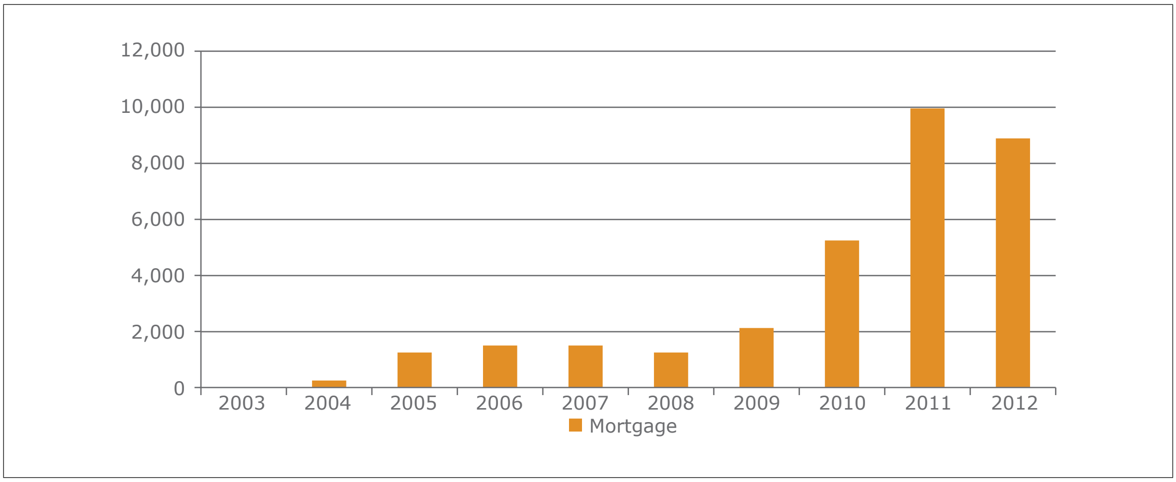
> https://www.pohjola.fi/pohjola/investor-relations/debt-investors/op-mortgage-bank?id=334200&srcpl=8&kielikoodi=en

> Figure 1: Covered Bonds Outstanding, 2003-2012, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2012, EUR m



Source: EMF/ECBC

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/19/Finnish_Covered_Bonds

3.11 FRANCE

French covered bond regulation was significantly modified in 2010 and 2011 with the strengthening of the SCF legal framework and the creation of *sociétés de financement de l'habitat* giving a specific legal framework to the existing French structured covered bond issuers based on the implementation of the European Collateral Directive N° 2002/47.

Consequently, three main covered bond issuing structures exist today in France:

> *Sociétés de crédit foncier*;

> *Caisse de Refinancement de l'Habitat*; and

> *Sociétés de financement de l'habitat*.

The French structured covered bond issuers that had not apply for their conversion into *société de financement de l'habitat* continue their activities.

A – SOCIETE DE CREDIT FONCIER

By Francis Gleyze, CIF Euromortgage

While many States allow ordinary credit institutions to issue covered bonds subject to the segregation of the cover pool in their balance sheet, France requires the set-up of an ad hoc company, the *société de crédit foncier* ("*SCF*") totally distinct from the other companies of the group to which it belongs and exclusively dedicated to the issuance of covered bonds named *obligations foncières* (*OFs*) and the management of the assets backing those issues (the "Cover Pool").

I. FRAMEWORK

SCF is governed by articles L.515-13 et seq. and R.515- 2 et seq. of the French Monetary and Financial Code (the "Code"). This stringent legal framework is specially designed to protect the holders of the OFs it issues.

The *SCF* is also governed by French general banking regulations.

II. STRUCTURE OF THE SOCIETE DE CREDIT FONCIER

The *SCF* is a credit institution licensed by the *Autorité de Contrôle Prudentiel*, the French Banking Authority with a single purpose: to grant or acquire eligible cover assets, as defined by Law, and to finance them by issuing *OFs*, which benefit from a special legal privilege giving them the right to be paid prior to all other creditors of the SCF (the "Privilege"). It may also issue or contract other debts benefiting or not from the Privilege.

In order to fulfil its obligations toward privileged debt holders, the *SCF* must ensure that its total assets constantly exceed the amount of the privileged debt it has issued and, for this purpose calculates a coverage ratio (the "Coverage ratio") which must be equal to or greater than 102%.

The *SCF* operates under the close control of the French Banking Authority, which requires it to comply with strict management rules in order to ensure control over risks.

Furthermore, and in addition to the nomination of two external auditors as all French credit institutions, the *SCF* is also required to appoint an independent controller (the "Specific Controller") whose mission, beyond the single monitoring of the Cover Pool, is more globally to ensure that the *SCF* complies with the regulations and especially with the Coverage ratio requirement.

III. COVER ASSETS

Only eligible assets, restrictively defined by Law, are authorized on the balance sheet of the *SCF*. All assets on the balance sheet are part of the cover pool.

Assets eligible to the cover pool are:

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

> loans granted to finance real estate and guaranteed by a credit institution or an insurance company with shareholders' equity of at least EUR 12 m and that isn't a member of the group to which belongs the *SCF*. The amount of these loans cannot exceed 35% of the total assets of the *SCF*;

> public exposures that are totally guaranteed by:

a) Central administrations, central banks, public local entities and their grouping, belonging to a member State of the European Community or party to the European Economic Area, or - under rating 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;

b) European Community, International Monetary Fund, Bank for international Settlements and mul¬tilateral developments banks registered by the French Ministry of Finance;

c) Other public sector entities and multilateral development banks as described in Article L.515-15 of the Code;

> senior securities issued by French securitisation vehicles or equivalent entities subject to the law of a Member State of the European Community or party to the European Economic Area, USA, Switzerland, Japan, Canada, Australia and New Zealand whose assets are composed, at a level of at least 90%, of loans and exposures directly eligible to the cover pool. The assets of the securitisation vehicles or equivalent entities may only consist of mortgage loans or public sector exposures, and under no circumstances, may be backed by assets created by consolidating or repackaging multiple securitisations. To be eligible to the cover pool, the senior securities issued by the securitisation vehicles or similar entity must qualify as a minimum for the credit quality assessment step 1 by a rating agency recognised by the French Banking Authority.

Such senior securities cannot exceed 10 % of the nominal amount of the outstanding issue. However, until 31 December 2017, the 10 % limit shall not apply, provided that:

> the loans carried by the securitisation vehicles were originated by a member of the same consolidated group of which the issuer of the covered bonds is also a member or by an entity affiliated to the same central body to which the issuer of the covered bonds is also affiliated (that common group membership or affiliation to be determined at the time the senior securities are made as collateral for covered bonds); and

> a member of the same consolidated group, of which the issuer of the covered bonds is also a member or an entity affiliated to the same central body to which the issuer of the covered bonds is also affiliated, retains the whole first loss tranches supporting those senior securities.

By 31 December 2016, the European Commission shall review the appropriateness of the derogation set out in the third paragraph and, if relevant, the appropriateness of extending similar treatment to any other form of covered bonds.

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

> liquid and secured assets (the "Substitution Assets") up to 15 % of the amount of the outstanding covered bonds issued by the *SCF*. Substitution Assets are: securities, assets and deposits for which the debtor is a credit institution or an investment company qualifying for the step 1 credit quality assessment (with a maturity up to 100 days for a credit institution or an investment company subject to the law of a Member State of the European Community or party to the European Economic Area and qualifying for the step 2 credit quality assessment).

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

IV. VALUATION AND LTV CRITERIA

Loans in the Cover Pool can be financed by *OFs* and other privileged debt up to the amount of:

> the remaining principal balance of the loan, or

> the value of the real estate financed or given as collateral multiplied by the financing coefficient, whichever is lower.

This financing coefficient is equal to:

> 60% of the value of the financed real estate, for guarantied loans, or of the assets given as collateral, for residential mortgages,

> 80% of the value of the real estate in the case of loans that were granted to individuals either to finance the construction or purchase of a home, or to finance both the acquisition of the undeveloped land and the cost of building the home.

> 100% of the value of the real estate financed, in the case of loans guarantied by the *Fonds de garantie à l'accession sociale* (Guaranty Fund for Social Home Accession).

The real estates financed by the loans are valued according to the French mortgage market accepted practice. The real estates values are based on the index provided by INSEE (*Institut National de la Statistique et des Études Économiques*) or on the index provided by Notaries (PERVAL). The real estates are revaluated on an annual basis.

Real estate valuations must be based on their long-term characteristics. Under banking regulation N° 97-02, real estate values are considered as part of the risks of the *SCF*. The valuations are made by independent experts in compliance with banking regulation.

Among his duties, the Specific Controller controls the eligibility, composition and valuation of the assets.

V. ASSET - LIABILITIY MANAGEMENT

The *SCF* must comply with assets/liabilities rules as required by banking regulations and, in particular, it is required to match its assets and liabilities in terms of interest rates and maturities.

Coverage ratio - Overcollateralization

The total value of the assets of a *SCF* must, at all times, be greater than the total amount of liabilities benefiting from the Privilege, a condition that makes, initially, for a Coverage ratio always greater than 100%, increased to 102% by decree N° 2011-205.

From a regulatory standpoint, the Coverage ratio is calculated on the basis of the *SCF* accounting data by applying different weights to classes of assets:

> loans secured by a first-ranking mortgage or by an equivalent guarantee are weighted 100% up to their part eligible for privileged debt financing;

> loans guaranteed by a credit institution or an insurance company are weighted 100% if the guarantor qualifies, at least, for the step 2 credit quality assessment, weighted 80% if it qualifies for the step 3 credit quality assessment, and weighted 0% in any other case;

> public exposures and replacement assets are weighted 100%; and

> senior securities of securitisation vehicles are weighted 100%, 80%, 50% or 0% subject to different criteria including, essentially, their rating.

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

Market risks

SCF must manage and hedge market risks on its assets, liabilities and off-balance sheet items: interest rate risks, currency risks, liquidity and maturity mismatch between liabilities and assets. The surveillance of these points is part of the duties of the Specific Controller.

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, *OFs* 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.

Liquidity risk

Since the adoption of Law N° 2010-1249 of 22 October 2010 and Decree N° 2011-205, SCFs are required to ensure that their cash needs are constantly covered over a moving period of 180 days. The scope of this new obligation will extend to forecasted principal and interest flows involving the *SCF*'s assets, as well as to flows related to its trading of financial futures stipulated in CMF § L.515-18. Cash needs may be covered, if necessary, by replacement securities, assets eligible for Bank of France refinancing, and repurchase agreements with credit institutions that have the highest short-term credit ratings or whose creditworthiness is guarantied by other credit institutions that have the highest short-term credit ratings.

As the SFH, *SCF* is authorized to subscribe to its own *OFs* up to 10% of total privileged liabilities provided that these OFs are only used as collateral with the central bank or cancels them within 8 days.

General risks

As credit institutions on general, the *SCF* is, subject to the banking regulation N° 97-02 on internal control. Accordingly, it must set up a system for monitoring transactions and internal procedures, a system for handling accounting processes and data processing, as well as risk management and monitoring systems.

VI. TRANSPARENCY

As a credit institution and listed company, the *SCF* must issue periodic financial information and, in accordance with French regulation N°97-02, a report on risk management.

Moreover, the *SCF* is also required to publish:

> A quarterly report relating to the nature and the quality of their assets. This report must be published in the *Bulletin des Annonces Légales Obligatoires*, in any newspaper enable to publish legal announcements or on their website;

> An annual report describing (i) the nature and the quality of its assets, the characteristics and breakdown of loans and guaranties, the amount of defaults, the breakdown of receivables by amount and by class of debtors, the proportion of early redemptions, the list and characteristics of senior securitisation securities and RMBSs it holds, the volume and breakdown of replacement securities it holds and (ii) the extent and

sensitivity of their interest-rate exposure. This report is published in the *Bulletin des Annonces Légales Obligatoires* after the annual shareholders' General Meeting;

> A semi-annual report, on 30 June and 31 December of each year relating to the amount of its Coverage ratio, the compliance with the limits it is requested to respect i.e. the 35% limit of guaranteed loans, the 10% limit of mortgage promissory notes, etc. This report is certified by the Specific Controller and transmitted to the French Banking Authority.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The Specific Controller is appointed by the *SCF* with the agreement of the French Banking Authority. To ensure his independence, the Specific Controller may not be an employee of either of the *SCF*'s independent auditors, of the company that controls the *SCF*, or of any company directly or indirectly controlled by a company that controls the SCF.

The mission of the Specific Controller involves the following verifications:

> That all assets granted or acquired by the *SCF* are eligible to the cover pool, and in the case of mortgage assets, that they are properly valued;

> That the Coverage ratio is, at any moment, at least, at 102%;

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

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

> That, on general, the *SCF* complies with the law and regulations.

The Specific Controller certifies that the *SCF* complies with the Coverage ratio rules on the basis of a quarterly issuance program, and for any issue of privileged debt of an amount equal or above EUR 500 m. These Coverage ratio affidavits are required to be stipulated in issuance contracts where the debt ben¬efits from the Privilege.

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

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

SCF operate under the constant supervision of the French Banking Authority.

Its management, its Specific Controller and its Independent Auditors should be agreed by the French Banking Authority.

All the above mentioned reports should be sent to the French Banking Authority together with the annual report of the Specific Controller and the report of the annual reports of the Independent Auditors.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS

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

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

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

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

> The common provisions of French bankruptcy law affecting certain transactions, which entered into force during the months prior the insolvency proceedings (the *période suspecte*), are not applicable to *SCF*.

As an exception to the general French bankruptcy law, bankruptcy proceedings or liquidation of a company holding share capital in a *SCF* cannot be extended to the *SCF*. As a result, *SCF* is totally bankruptcy remote and enjoy full protection from the risks of default by their parent company or the group to which they belong.

IX. RISK- WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

OFs comply with the requirements of article 52 par. 4 of the UCITS directive, and with the CRD directive, Appendix VI, Pact 1, Par. 65 a) to f).

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

X. ADDITIONAL INFORMATION

Covered bonds liquidity

The French *SCFs* which issue jumbo *OFs* have together signed with more than 20 banks a specific standardised market-making agreement, which has become a national agreement.

B - CAISSE DE REFINANCEMENT DE L'HABITAT (CRH)

By Henry Raymond, Caisse de Refinancement de l'Habitat

I. FRAMEWORK

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

Up to the creation of the SFEF (*Société de financement de l'économie française*) in October 2008, no other agency of that type was created in France. Since 1 January 2010, CRH has been appointed to control debt' service and collateral administration of the SFEF.

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

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

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

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

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

They are governed by the article 13 of act 1985-695 of 11 July 1985 as complemented by article 36 of act 2006-872 of 13 July 2006.

CRH received approval to issue bonds under article 13 of act 1985-695 by letter of 17 September 1985 from the Minister for the Economy, Finance and Budget.

CRH's operations are governed by the provisions of 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. STRUCTURE OF THE ISSUER

Caisse de Refinancement de l'Habitat, a French corporation (*société anonyme*), is a credit institution licensed to operate as a financial company (*société financière*) by virtue of the decision taken on 16 September 1985 by the French Credit Institutions Committee (*Comité des Établissements de Crédit*).

CRH is therefore governed by the provisions of Articles L. 210-1 to L. 228-4 of the French commercial Code and Articles L. 511-1 *et seq.* of the French Monetary and Financial Code.

Its equity belongs to French banks:

> Crédit Agricole SA – Crédit Lyonnais	36,9 %
> Crédit Mutuel – CIC	33,0 %
> Société Générale	13,8 %
> BNP Paribas	10,0 %
> BPCE	5,7 %
> Others	0,6 %

Every borrower is committed to become a shareholder of CRH with a part in CRH's equity equal to the part of its borrowings in CRH's global loans amount. That breakdown is also the breakdown of CRH's loans. Furthermore, every borrower is committed to supply back up lines to CRH if CRH calls them.

These shareholders-borrowers are among the best European names. Their global market share is roughly 90% of the French Mortgage Market

III. COVER ASSETS

CRH's loans to banks (represented by promissory notes) are covered by the pledge of eligible loans kept in balance sheets of borrowing banks.

Eligible loans are only home loans to individuals defined by law: first-ranking mortgages or guaranteed loans.

The cover pool which include exclusively residential loans are CRD compliant and secured by first rank mortgages (80 % area of the pool) or, under certain conditions by guarantees (de facto 20 % of the pool).

Guaranteed loans are loans with the guarantee of a credit institution or an insurance company (the total amount of these loans cannot exceed 35% of the covering portfolio).

CRH's internal rules only allow French residential loans with maturity under 25 years and size under EUR 1 million.

The total value of the cover pool must equal at least 125% of the total amount of CRH loans (equal to the total amount of CRH bonds) – 150% if floating rate loans.

The geographical area for eligible loans is the European Economic Area (EEA) in the law but "de facto" only France and overseas territories. Public sector assets are not eligible.

No replacement assets are allowed. RMBS and other loans are not eligible.

IV. VALUATION AND LTV CRITERIA

The rules for real estate valuations are the same as those of *sociétés de credit foncier*.

All buildings financed by eligible loans are the subject of a prudent evaluation that excludes all speculative aspects. It is carried out by the borrowing bank.

This valuation must be performed by an independent expert, i.e. a person who is not part of the lending decision-making process.

The valuation is performed taking into account the building's long-term characteristics, normal and local market conditions, the current use made of the asset and all other uses that might be made.

The valuation of the buildings is re-examined as part of the risk measurement system required of borrowing credit institutions by CRBF Regulation no. 97-02. This examination is performed annually using statistical methods.

Loan to value must not exceed 80% (de facto 90% because of the over-sizing of the covering portfolio by 25%).

V. ASSET - LIABILITY MANAGEMENT

CRH's debts and loans (represented by notes) have exactly the same characteristics. CRH is not submitted to an interest rate risk. CRH is not affected by early repayment of loans included in the portfolio.

According to CRH internal regulation, the cover pool must be congruent with rate and duration of CRH's debt to protect CRH in the case where it becomes owner of the cover pool.

VI. TRANSPARENCY

Every year, the annual report publishes the size of the cover pool. This report confirms the characteristics (nature and quality) of home loans pledged and that CRH is not exposed to interest rate risk.

CRH applying for the ECBC Label will publish during the second semester 2013 on a quarterly basis data information on its cover pool required by the National Transparency Template.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

CRH is an independent credit institution that doesn't borrow for its own account but for the account of banks and doesn't charge any fee or interest margin on its refinancing transactions.

CRH regularly achieves, based on sampling, audits on the cover pool, carried out at the borrowing banks. If necessary, CRH asks borrowing banks to increase the cover pool to compensate for the shortfall identified or to pay back CRH by delivering CRH's bonds.

As a credit institution, CRH is under the general supervision of the French banking authority *l'Autorité de contrôle prudentiel*. Furthermore, its operations are under a specific supervision of *l'Autorité de contrôle prudentiel* 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. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

In the case of a borrowing bank default, CRH becomes owner of the portfolio of housing loans without any formality notwithstanding any provision to the contrary.

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

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

CRH's debt has been rated AAA and Aaa (senior unsecured) by Fitch and Moody's since 1999.

CRH's bonds are compliant with criteria of article 52(4) of the 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 (ECB) open market operations.

X. ADDITIONAL INFORMATION

CRH belongs to covered bonds world but is very different from other issuers:

> CRH is a former agency created by French government,

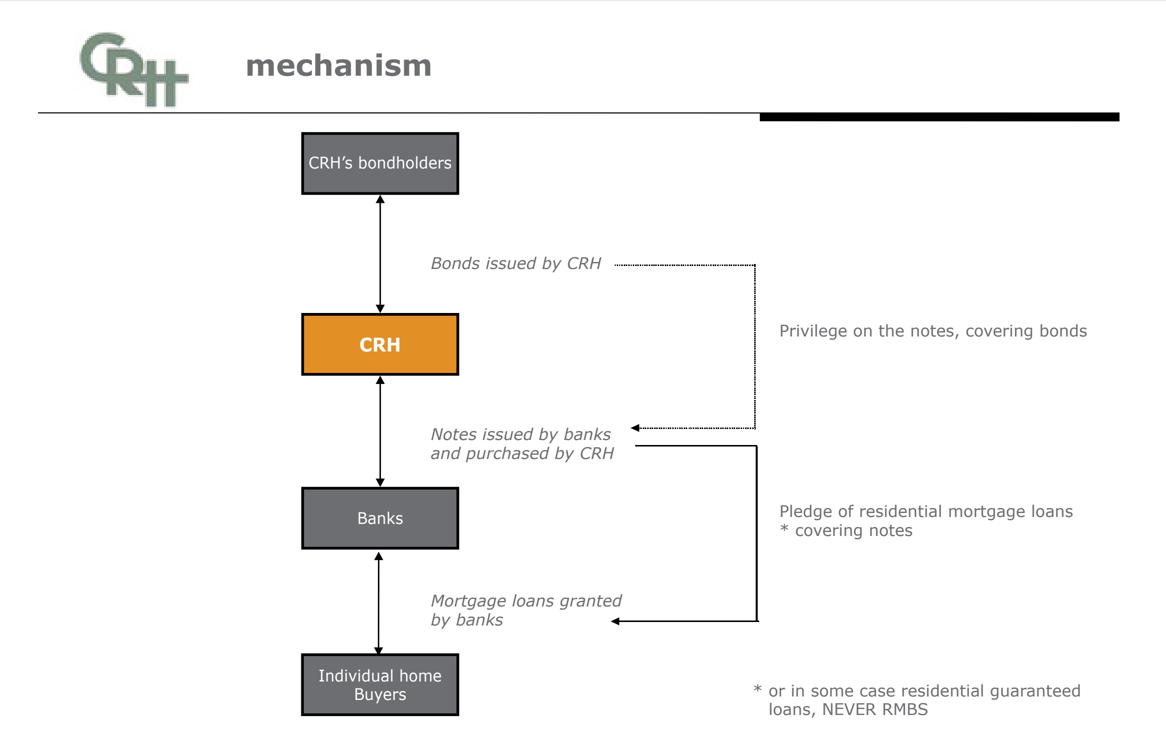
> CRH is regulated by specific legal framework dedicated to it,

> CRH is not borrowing for itself but for the account of French Banking system,

> CRH is a credit institution of full exercise able to refuse to fund a shareholder,

> CRH benefits from cross commitments of French's banks to supply cash advances and capital contributions.

FIGURE 1: MECHANISM



C – OBLIGATIONS DE FINANCEMENT DE L'HABITAT

By Cristina Costa, Natixis, Boudewijn Dierick, BNP Paribas, Diane Jammaron, BNP Paribas and Jennifer Levy, Natixis

The first structured covered bond was issued in late 2006 using contractual agreements instead of the existing legal covered bonds *Obligations Foncières* framework. In order to provide a statutory framework for the growing number of French structured covered bond issuers, the law on banking and regulation was adopted in October 2010[1] (several regulations has been issued from the French regulator since then) setting up new status of home financing company or *Société de Financement de l'Habitat* (SFH) has been set up by the law on banking and regulation was adopted in October 2010[1] (and several regulations has been issued from the French regulator since then). The SFH legislation is intended to give a specific legislative framework to French structured covered bonds backed by residential home loans. The SFH and the *Société de Crédit Foncier* (SCF) are now subject to the same law and regulations (specific controller, coverage ratio, liquidity ratio, etc.) implemented in the French Monetary and Financial Code (the Code). Segregation of assets is based on the European Collateral Directive and/or true sale, which has been transposed into the French Monetary and Financial Code.

Under the SFH legislation, the holders of the *Obligations de Financement de l'Habitat* (OH) benefit from a legal privilege granted over the SFH programme's assets (according to article L. 515-19 of the Code). If the issuer becomes insolvent, the OHs and other privileged debts are paid in priority and in accordance with their payment schedule, over any of the programme's other debts or non-privileged creditors in relation to the SFH's assets.

Since 2011, according to the SFH law almost all French common-law based covered bond issuers[2] have opted for the SFH status, being a credit institution licensed as a finance company by the French supervisor (*Autorité de Contrôle Prudentiel*) may, if it complies with article 73 and seq. of the Code.

I. FRAMEWORK

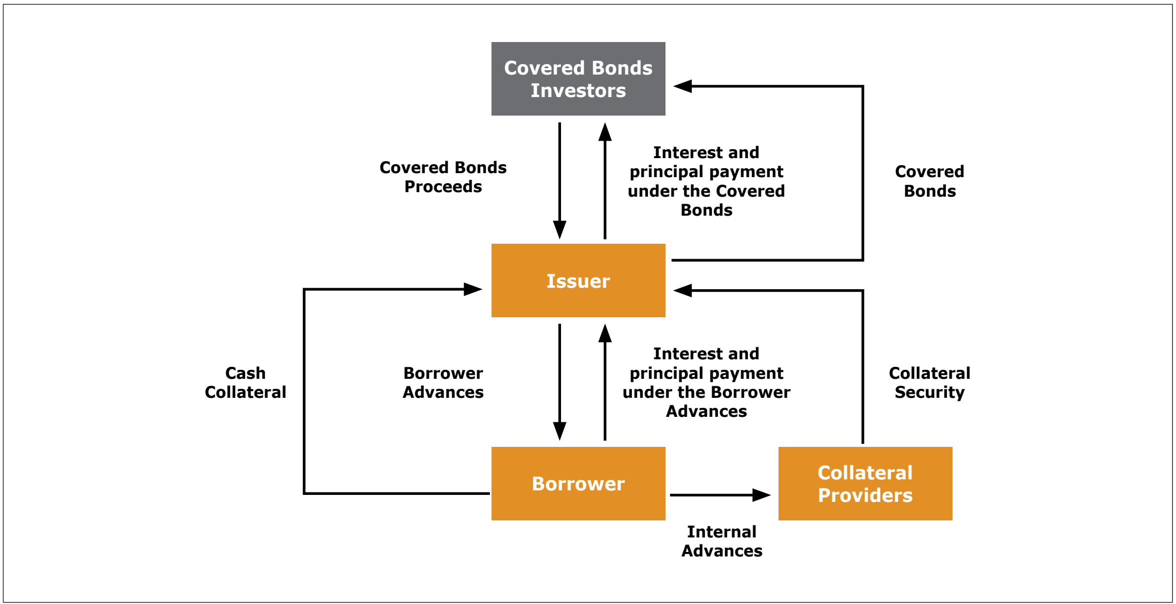
The SFH structure makes use of the implementation of the EU Collateral Directive 2002/47/EC, as amended, under French law (implemented into the Code under articles L. 211-36 and seq.), which allows for a segregation through a specific pledge of the assets without any actual transfer (true sale) of assets to the issuer.

The sponsor bank pledges or assigns cover assets (i.e. residential home loans), as collateral to a dedicated subsidiary, which is a regulated French credit institution with limited purpose licensed as a SFH (e.g. issuing covered bonds for the purpose of providing financing to the sponsor bank). The covered bonds proceeds are used to fund advances to the respective sponsor bank(s). The covered bonds are secured by the legal privilege over the assets of the issuer (advances to the sponsor bank(s)), which are in turn secured by a pledge over cover assets (i.e. residential home loans), which remain on the sponsor bank's balance sheet (and/or on the balance sheets of the respective subsidiaries, affiliates or group member banks). Pursuant to article L.211-38 of the Code, the pledge shall be enforceable even when the relevant collateral provider is subject to an insolvency proceeding, so upon a borrower enforcement notice (for example in case of default of the sponsor bank), the respective cover assets, including underlying securities, will be transferred without any formalities to the covered bond issuer.

All the French OH issuers choose the dual structure.

1 Law n°2010-1249 dated 22 October 2010 and Decree n° 2011-205 dated 23 February 2011.
2 Except two issuers (Banques Populaires Covered Bonds and Groupe Caisse d'Epargne Covered Bonds).

Figure 2: Structure of Obligation de Financement de l'Habitat (Dual Structure)



Sources: Moody's, Natixis

II. STRUCTURE OF THE ISSUER

The sole purpose of SFH is to grant or to finance home loans and to hold securities or instruments under the conditions set out by the law and financial regulations. Under a SFH programme (EMTN), the issuer issues *Obligations de Financement de l'Habitat* (OHs) which are unsubordinated senior secured obligations and rank *pari passu* among themselves benefiting from the legal privilege.

These specialised credit institutions are usually an affiliate of the sponsor bank. There are currently seven SFH issuers:

BNP Paribas Home Loan SFH (99.9% owned by BNP Paribas), BPCE SFH (99.9% owned by BPCE S.A.), Crédit Mutuel Arkea Home Loans SFH (affiliate of the Crédit Mutuel Arkéa group), Crédit Mutuel-CIC Home Loan SFH (a subsidiary of Banque Fédérative du Crédit Mutuel), Crédit Agricole Home Loan SFH (99.9% owned by Crédit Agricole S.A.), HSBC SFH (France) (a subsidiary of HSBC France) and Société Générale SFH (a subsidiary of Société Génerale).

III. COVER ASSETS

Pursuant to the SFH Law, the eligible cover assets of a SFH comprise, inter-alia:

> Home loans (*prêts à l'habitat*) which include (i) loans secured by a first-ranking mortgage or other real estate security interests that are equivalent to a first-ranking mortgage ("*hypothèque de premier rang ou une sûreté immobiliere conferant une garantie au moins equivalente*"[3]) or (ii) loans that are guaranteed by a credit institution or an insurance company ("*cautionnement consenti par un établissement de crédit ou une entreprise d'assurance*"). The property must be located in France or in any other Member State of the European Union or the European Economic Area (EEA) or in a State benefiting from the highest level of credit assessment.

3 Art. L515-35, II, 2° of the Code

> Loans guaranteed by the *Fonds de Garantie à l'Accession Sociale à la Propriété* (Guarantee Fund for Social Access to Home Ownership)

> Loans secured by the remittance, the transfer or the pledge of the receivables arising from the home loans referred above,

> Senior Units or notes [(other than subordinated units or subordinated notes)] issued by French securitisation vehicles, or other similar vehicles governed by the laws of a Member State of the EU or the EEA if (i) their cover assets comprise at least 90% of secured loans or other receivables benefiting from the same level of guarantees and (ii) such units or notes benefit from the highest level of credit assessment ("meilleur échelon de qualité de credit") promissory notes (*billets à ordre*), and

> substitution assets (*valeurs de remplacement*), under certain liquidity and maturity conditions and provided that their aggregate value is up to a maximum amount of 15% of the outstanding covered bonds.

Under the SFH Law, senior units or notes issued by securitisation vehicles (*organismes de titrisation*) are only eligible as cover assets to support covered bond issuance if they are rated Aa3/AA- or above (100% eligible) or A3/A- or above (50% eligible). ABS/RMBS count as eligible cover assets depending on the originator, the rating of the securitisation, and the time at which the senior units or notes were purchased by the issuer.

Weightings of ABS/MBS for *Sociétés de Crédit Foncier and Sociétés de Financement de l'Habitat*:

If the underlying assets of the ABS/MBS were originated by the group and they were acquired by the issuer after 31 December 2011, the securities count as collateral with the following ratings:

> 100% as long as they are rated Aaa/AAA;

> 80% if the rating is between Aa3/AA- and Aa1/AA+;

> 0% if the rating is below Aa3/AA-

If the underlying assets of the ABS/MBS were originated by the group and they were acquired by the issuer before 31 December 2011 or after 31 December 2014, the securities count as collateral with the following ratings:

> 100% as long as they are rated Aaa/AAA;

> 50% if the rating is between Aa3/AA- and Aa1/AA+;

> 0% if the rating is below Aa3/AA-

If the underlying assets of the ABS/MBS were transferred by an institute that is not a member of the same group as the covered bond issuer and they were acquired by the issuer after 31 December 2011 but before 31 December 2014, the securities count as collateral with the following ratings:

> 100% as long as they are rated Aaa/AAA;

> 50% if the rating is between Aa3/AA- and Aa1/AA+;

> 0% if the rating is below Aa3/AA-

If the underlying assets of the ABS/MBS were transferred by an institute that is not a member of the same group as the covered bond issuer and they were acquired by the issuer before 31 December 2011 but after 31 December 2014, the securities count as collateral with the following ratings:

> 100% as long as they are rated Aaa/AAA;

> 0% if the rating is below Aaa/AAA.

N.B. These weightings are also applicable to *Sociétés de Crédit Foncier*

The SFH regulation also applies a haircut to in-house guarantors as presented in more detail in the box below.

Weighting of guaranteed home loans for *Sociétés de Financement de l'Habitat*:

When the home loan guarantor is not part of the same consolidation scope as the SFH or the SCF, the weighting is as follows:

> 100% when the home loan guarantor has at least the second highest level awarded by a rating agency (≥A3/A-/A- by Moody's/S&P/Fitch);

> 80% when the home loan guarantor has at least the third highest level of quality awarded by a rating agency (≥Baa3/BBB-/BBB- by Moody's/S&P/Fitch);

> 0% in all other cases.

When the home loan guarantor is part of the same consolidation scope as the SFH, the guaranteed home loans are weighted as follows:

> 80% when the home loan guarantor has at least the second highest level of quality awarded by a rating agency (≥A3/A-/A- by Moody's/S&P/Fitch);

> 60% when the home loan guarantor has at least the third highest level of quality awarded by a rating agency (≥Baa3/BBB-/BBB- by Moody's/S&P/Fitch)

> 0% in all other cases.

IV. VALUATION AND LTV CRITERIA

The properties are valued according to the French mortgage market accepted practice. The property values are indexed to the French INSEE (*Institut National de la Statistique et des Etudes Economiques*) or PERVAL (Notaries) house price index on a quarterly basis. In most programmes, price decreases are fully reflected in the revaluation, while in the case of price increases, a 20% haircut is applied even though this is not required by law. This valuation is assessed in an annual report published by the SFH and certified by the specific controller[4].

In order to ensure overcollateralization (the rating agencies' levels are far above the 2% minimum required by law), the SFH programmes also include a dynamic Asset Coverage Test (ACT) that requires the balance of the cover assets pool to significantly exceed the balance of the outstanding covered bonds. The minimum level of OC will depend on the credit quality of cover assets as assessed by the rating agencies. For all the existing programmes the maximum asset percentage applied in the ACT is 92.5%, which translates into a minimum overcollateralization of at least 8%. However, that being said all SFH programmes currently exceed the minimum amount due to adjustments to the most recent rating agency methodologies.

When calculating the appropriate cover assets balance within the Asset Coverage Test (ACT), higher LTV loans are included in the cover assets, but loan amounts exceeding the respective cap do not get any value in the ACT. For all programmes, the LTV ratio of the loans cannot be more than 100% (however, the portion that is above 80% will be disregarded in the ACT). In addition, the ACT gives no value to the loans in arrears or defaults.

V. ASSET-LIABILITY MANAGEMEMT

Overcollateralisation: By law, the SFH must maintain a nominal overcollateralisation ratio of 2% on the adjusted cover assets balance at all times.

4 Pursuant to the ACP regulation CRBF 99-10.

Liquidity buffer: The SFH framework also requires the SFH to cover, at all times, its treasury needs over a period of 180 days, taking into account the forecasted flows of principal and interest on its cover assets and net flows related to derivative financial instruments.

Liquidity: The SFH framework provides further liquidity means by allowing, as a last-recourse funding option, the SFH to subscribe to its own privileged covered bonds – up to 10% of total privileged liabilities – provided that the SFH uses these OHs as collateral with the central bank within 8 days or cancels these OHs. The above requirements are also applicable to SCF.

In addition to the requirements specified by the SFH Law, all French OH programmes include a number of safeguards to hedge interest rate and currency risks, refinancing risk, commingling risk, set–off risk, market risk, etc, as follows:

> Interest rate and currency risks need to be neutralised (by structuring a hedging strategy[5]); subject to certain rating triggers, swaps with suitable counterparties have to be entered into by the SFH to ensure that exposure to market risk is properly hedged.

> Liquidity is ensured through a pre-maturity test (designed to ensure that sufficient cash is available to repay the covered bonds in full, on the original maturity date in the event of the sponsor bank's insolvency) and/or in case of soft bullet coverd bonds on the extended maturity extension;

> Cash flow adequacy is secured through the asset-coverage test and the contractual obligation to hedge any exposure to interest rate and currency risk.

> Commingling risk is mitigated by the hedging strategy and the Collection Loss Reserve Amount.

> Minimum rating requirements are also in place for the various third parties that support the transaction, including the bank account holder and swap counterparties.

VI. TRANSPARENCY

As a credit institution and as the *SCF*, every SFH must issue periodic financial information and, in accordance with French regulation N°97-02, a report on risk management.

Moreover, the *SCF* is also required to publish:

> A quarterly report relating to the nature and the quality of their assets. This report must be published in the *Bulletin des Annonces Légales Obligatoires*, in any newspaper enable to publish legal announcements or on their website;

> An annual report describing (i) the nature and the quality of their assets, the characteristics and breakdown of loans and guaranties, the amount of defaults, the breakdown of receivables by amount and by class of debtors, the proportion of early redemptions, the list and characteristics of senior securitisation securities and RMBSs they may hold, the volume and breakdown of replacement securities they hold and (ii) the extent and sensitivity of their interest-rate exposure. This report is published in the *Bulletin des Annonces Légales Obligatoires* after the annual shareholders' General Meeting;

> A semi-annual report, on 30 June and 31 December of each year relating to the amount of its Coverage ratio, the compliance with the limits they are requested to respect.This report is certified by the Specific Controller and transmitted to the French Banking Authority.

Some/most of SFH have also registered to the European Cover Bonds Label since January 2013 and published data according to the Label templates.

5 Article L. 515-22 of the Code

VII. COVER POOL MONITORING & BANKING SUPERVISION

The issuing bank is responsible for the monthly pool monitoring, with the asset coverage test calculation being checked by an independent Asset Monitor (and by the specific controller – some SFH do not have both): under the terms of the asset monitor agreement, the asset monitor tests the calculation of the asset coverage test annually. In case of non-compliance with the asset coverage test or in case the senior unsecured rating of the sponsor bank drops below a predefined trigger rating level, the test has to be performed on a monthly basis. In addition, rating agencies are involved in the programme and re-affirm the ratings of the programme upon a pre-defined issuance volume. They also monitor the amount of overcollateralisation required to maintain the triple-A ratings.

Under SFH Law, each issuer has to appoint a Specific Controller (*Contrôleur Spécifique*), and a Substitute Specific Controller (*Contrôleur Spécifique Suppléant*), who are selected from an official list of external auditors and are appointed subject to the prior approval of the ACP. Their role is (i) to ensure that the issuer complies with the SFH Law (in particular, by verifying the quality and the eligibility of the assets and the cover ratios the Issuer has to comply with), (ii) monitor the balance between the Issuer's assets and liabilities in terms of rates and maturity (cash flow adequacy) and (iii) notify the Issuer and the ACP if he considers such balance to be unsatisfactory. The Specific Controller remains liable, both as regards the Issuer and third parties, for any loss suffered by them, which results from any misconduct or negligence arising in the performance of its duties. The Specific Controller verifies key financial aspects of the activities of the Issuer, in particular the extent of the collateral for the covered bonds. He is independent from both the Issuer and the Sponsor Bank. Furthermore, for every issuance with an amount exceeding EUR 500 m, the specific controller must attest the compliance of the cover ratio on the basis of the quarterly programme of debt issued benefiting from the privilege.

VIII. SEGREGATION OF COVER ASSETS & BANKRUPTCY REMOTENESS

Under the SFH legislation, the holders of the OHs benefit from the legal privilege over the SFH programme's eligible assets.

The issuer may be subject to insolvency but the SFH law, (the same applies for the SCF provides for a regime which derogates in many ways from the French insolvency provisions:

> **Legal Privilege / No acceleration of covered bonds as a result of insolvency of SFH**: in the event of an insolvency proceeding of the SFH (safeguard procedure, judicial reorganization or liquidation), all claims benefiting from the Privilège[6] (including interest) must be paid on their due dates and in preference to all other claims. Until payment in full of all such preferred claims, no other creditors may take any action against the assets of the SFH.

> **No nullity during the hardening period**: the provisions allowing an administrator to render certain transactions entered into during the hardening period (période suspecte) null and void are not applicable for the transfer of cover assets entered into by a SFH (provided that such transactions are made in accordance with their exclusive legal purpose and without fraud).

> **Option to terminate ongoing contracts with insolvent counterparties**: in case of the opening of any insolvency procedure against the credit institution, which is acting as manager and servicer of the SFH, any contract may be immediately terminated by the SFH notwithstanding any legal provisions to the contrary.

> **No Consolidation**: SFH law precludes the extension of any insolvency procedure in respect of the SFH's [Main] shareholders to the SFH itself.

6 Principal and interest of the Covered Bonds benefit from the so called "Privilège" (priority right of payment). As a consequence, and notwithstanding any legal provisions to the contrary, all amounts payable to the issuer in respect of the cover pool and forward financial instruments are allocated in priority to the payments of any sums due in respect of the covered bonds.

IX. RISK-WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

The SFH meet the requirements of Article 52(4) of the UCITS directive. In France and abroad, French OH currently have a 20% risk-weighting under the CRD III Standard Approach.

However, on the 16 April 2013, the European Parliament finally approved the CRR/CRD IV package, which, subject to formal approval by the Council of Ministers, is expected to come into force on the 1 January 2014. Article 129 CRR defines which assets are eligible as collateral for covered bonds to ensure a lower risk-weighting. French guaranteed home loans (*prêts cautionnés*) will be eligible for preferential treatment subject to a number of conditions: (i) the eligible guaranteed home loan provider qualifies for credit quality step 2 or above (i.e. rated minimum A3/A-/A- by Moody's, S&P and Fitch); ii) the portion of each of the loans that is used to meet the requirement for collateralization of the covered bonds does not represent more than 80% of the value of the corresponding residential property located in France (i.e. guaranteed home loans comply with the 80% LTV limit), and (iii) where a loan-to-income ratio is limited to 33% when the loan has been granted. Furthermore, for the loans granted from 1 January 2014 the borrower shall be contractually committed not to grant such liens without the consent of the credit institution that granted the loan. The loan-to- income ratio represents the share of the gross income of the borrower that covers the reimbursement of the loan, including the interests. The protection provider shall be either a financial institution authorized and supervised by the competent authorities and subject to prudential requirements comparable to those applied to institutions in terms of robustness or an institution or an insurance undertaking. It shall establish a mutual guarantee fund or equivalent protection for insurance undertakings to absorb credit risk losses, whose calibration shall be periodically reviewed by the competent authorities. Both the credit institution and the protection provider shall carry out a creditworthiness assessment of the borrower.

Under the Standardised Approach, the risk weighting of covered bonds will be based on the rating of the covered bond and no longer on that of the credit institution or the sovereign. In order to qualify for this preferential treatment, the new regulation requires the issuers to provide up-to-date portfolio information to investors on an ongoing basis, at least quarterly.

> Figure 3: CB risk weights under the standard approach (CB rating assigned)

Credit Step	1	2	3	4	5	6
CB Rating	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	B+ to B-	≤CCC+
CB Risk weight	10.0%	20.0%	20.0%	50.0%	50.0%	100.0%

Source: CRD IV, Natixis

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

> Figure 4: CB risk weights under the standard approach (CB rating assigned)

Credit Step (Issuer)	1	2	3	4	5	6
Issuer's RW	20.0%	50.0%	50.0%	100.0%	100.0%	150.0%
CB Risk weight	10.0%	20.0%	20.0%	50.0%	50.0%	100.0%

Source: CRD IV, Natixis

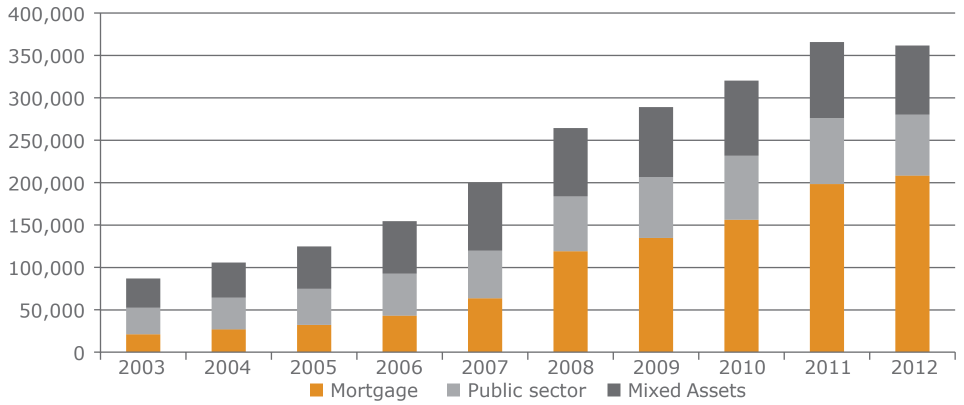
OH issuers respecting Article 129 CRR criteria should then benefit from preferential risk weighting (potentially 10% if the covered bonds have a rating of double-A minus or above).

Figure 5: Comparison of French covered bonds

	Obligation de Financement de l'Habitat
Legal Framework	French Monetary and Financial Code, Articles L.515-34 to L.515-39, Decree no. 2011-205 of 23 February 2011 and the Banking and Financial Regulation Act no. 2010-1249 of 22 October 2010
Issuer	duly licensed credit institution - with the status of financial company - Société de Financement de l'Habitat (SFH)
Eligible cover pools	- Residential home without limitation for guaranteed home loans and residential mortgages (commercial real estate loans are not eligible) - Securitization of the above (subject to specific rules and criteria)
Collateralisation	102%
Legal Privilege	Yes
LTV ratio	- First-rank residential mortgage loans and guaranteed home loans: max. 80% LTV - State-guaranteed real-estate loans: max. 100% LTV
Substitution assets	Max. 15% of total OF and other
Liquidity	Requirement to cover all cash flows for a period of 180 days, taking on principal and interests on its assets, and cash flows pertaining
Investor protection	Overcollateralisation, 180-day liquidity needs coverage and ability
Issue's structure/Transfer of assets	True sale of cover assets or loans secured by financial guarantees (articles L.211-38 and seq French Monetary & Financial Code - transposition of "Collateral" Directives)
Supervision	Autorité de contrôle prudentiel (ACP) - one specific controler - two
UCITS Compliant	Yes
Risk-weighting according to EU Credit institutions	20%

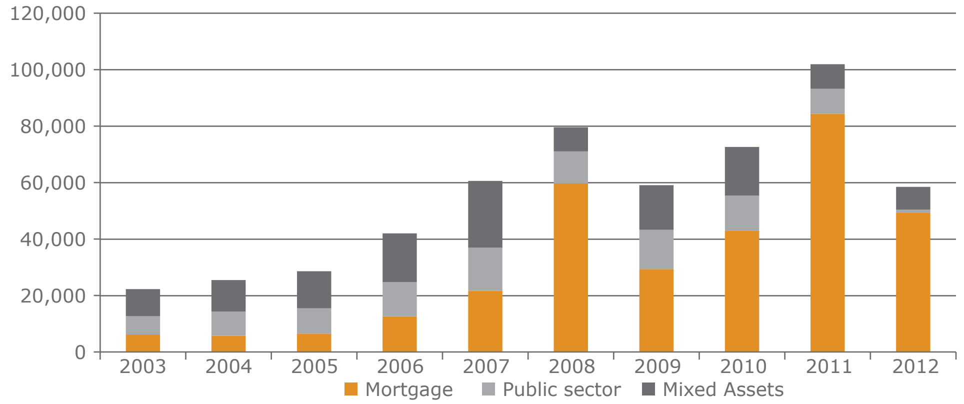
Obligations Foncières	Caisse de Refinancement de l'Habitat
French Monetary and Financial Code, Articles L.515-13 to L.515-33, regulation no. 99-10 of 9 July 1999. Amended by the Decree no. 2011-205 of 23 February 2011, Banking and Financial Regulation Act no. 1249 of 22 October 2010	French Monetary and Financial Code Articles L.313-42 to 313-49 and Art L.515-14-1, article 13 Law n°85-695 of 11 July 1985
duly licensed credit institution - with the status of financial company - Société de Crédit Foncier (SCF)	duly licensed credit institution - with the status of financial company -Caisse de Refinancement de l'Habitat (CRH)
- First-rank residential mortgage loans - First-rank commercial mortgage loans - State-guaranteed real-estate loans - Third party guaranteed real estate loans (max. 35% of total assets) - Public sector loans, bonds and leasing - Securitization of the above (subject to specific rules and criteria)	- First rank residential mortgage loans - State guaranteed mortgage loans - Third party guaranteed real estate loans (max. 35% of total assets) - No securitisation tranches, no RMBS - No loans with duration over 25 years - No loans with unit amount over €1m
102%	125%
Yes	Yes
- First-rank residential mortgage loans and guaranteed home loans: max. 80% LTV - First-rank commercial mortgage loans: max. 60% LTV - State-guaranteed real-estate loans: max. 100% LTV	- Residential mortgage loans: max 80% LTV, max 90 % LTV if overcollateralisation of 25% - State guaranteed mortgage loans: max 100% LTV
privileged resources.	Non eligible
into account all cash flows resulting of future payments to term instruments.	
to repo own issuances, controlled ALM	Overcollateralisation, full recourse to the participating banks in case of collateral shortfall
True sale nearly exclusively (but loans secured financial guarantee for "public exposures" legally possible)	ad hoc promissory notes exclusively secured by eligible cover pools
auditors - AMF (Autorité des Marchés Financiers)	Autorité de contrôle prudentiel (ACP) - two auditors - AMF (Autorité des Marchés Financiers)
Yes	Yes
10%	10%

> Figure 6: Covered Bonds Outstanding, 2003-2012, EUR m



Source: EMF/ECBC

> Figure 7: Covered Bonds Issuance, 2003-2012, EUR m



Source: EMF/ECBC

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/21/Caisse_de_Refinancement_de_l%27Habitat_-_CRH, http://ecbc.eu/framework/71/General_Law_Based_CBs, http://ecbc.eu/framework/73/Obligations_Fonci%C3%A8res_-_OF, http://ecbc.eu/framework/90/Obligations_%C3%A0_l%27Habitat_-_OH

3.12 GERMANY

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I. FRAMEWORK

In Germany, the legal basis for covered bond issuance is the German Pfandbrief Act (PfandBG – Pfandbriefgesetz) dated 22 May 2005. It supersedes the general bankruptcy regulation (§§ 30-36a of the Pfandbrief Act).

On 26 March 2009 amendments of the PfandBG came in force introducing a new Pfandbrief category, the Aircraft Pfandbrief, and furthermore enhancing the attractiveness of Pfandbriefe for investors. Among many improvements, a further liquidity safeguard has been implemented by introducing a special liquidity buffer of 180 days. Further amendments came into force on 25 November 2010, on 1 January 2011 and mid 2013 in order to strengthen the position of the special cover pool administrator. The last amendment of the PfandBG introduced further transparency requirements in favour of Pfandbrief investors, to be applied from spring 2014 on.

II. STRUCTURE OF THE ISSUER

Since 2005, the issuer of Pfandbriefe is no longer required to be a specialised bank. Instead, Pfandbrief issuers are allowed to exercise all activities of a credit institution, although a special licence for Pfandbrief issuance is required. The minimum requirements to obtain and keep the special licence are as follows:

> Core capital of at least EUR 25 million

> General banking licence which allows the issuer to carry out lending activities

> Suitable risk management procedures and instruments

> Business plan showing regular and sustainable issues as well as necessary organisational structure

Since the German outsourcing guidelines of the BaFin do not allow for the outsourcing of important and decision-making sections of the credit institution, the issuer is required to have its own employees. In addition, the PfandBG requires Pfandbrief banks to manage their own risk and take their own credit decisions on their own.

The issuer holds the cover assets on his balance sheet. A subsequent transfer of the cover assets to another legal entity does not take place. Given that a direct legal link between single cover assets and Pfandbriefe does not exist, all obligations relating to Pfandbriefe are obligations of the issuing bank as a whole, to be paid from all the cover assets of the issuer, recorded in the cover register. In the case of insolvency, the cover pool is segregated by law from the general insolvency estate and is reserved for the claims of the Pfandbrief holders. Even then, Pfandbrief holders still have a claim against the general insolvency estate.

III. COVER ASSETS

Cover assets are produced by mortgage lending, public sector lending, ship and aircraft financing activities. ABS/MBS are not eligible. A specific class of covered bonds corresponds to each of these cover asset classes: Hypothekenpfandbriefe, Öffentliche Pfandbriefe, Schiffspfandbriefe and Flugzeugpfandbriefe. The respective Pfandbrief must be fully secured by its specific cover asset class (§ 4 PfandBG). Detailed transparency requirements are regulated in § 28 PfandBG, enhanced by the amendments 2009, 2010 and 2013.

Up to 10% of the nominal volume of Pfandbriefe outstanding may consist of money claims against the European Central Bank, central banks in the European Union or against suitable credit institutions, which fulfil the requirements of credit quality step 1 according to Table 1 of the Annex VI of Directive 2006/48/EC.

The geographical scope of eligible mortgage assets is restricted to EU/EEA countries, to Switzerland, USA, Canada and Japan. Public sector loans to these countries are eligible for the cover of Öffentliche Pfandbriefe (§ 20 PfandBG). The total volume of loans granted in non-EU countries where it is not certain that the preferential right of the Pfandbrief creditors extends to the cover assets, may not exceed 10 % of the total volume of the cover loans (§§ 13 I 2, 20 I 2 PfandBG) and 20 % for ship and aircraft mortgages (§§ 22 V 2, 26b IV PfandBG).

Derivatives are eligible for cover pools under certain conditions. They must not exceed 12% of the cover assets when calculated on a net present value basis (§ 19 I 4. PfandBG).

IV. VALUATION AND LTV CRITERIA

Property valuation is regulated in § 16 PfandBG. This provision refers to the mortgage lending value (Beleihungswert) which is, in contrast to the market value, based on sustainable aspects of the property. Details about the valuation process and the qualifications of valuers are regulated in a specific statutory order on the mortgage lending value (Beleihungswertermittlungsverordnung, BelWertV), § 16 IV PfandBG.

Monitoring requirements result from the Capital Requirements Directive (once a year for commercial real estate and once every three years for residential real estate). In addition, § 27 BelWertV requires a review of the underlying assumptions when the market has declined substantially; a review of property values is also necessary when the loan has defaulted.

The BelWertV requires personal and organisational independence of the valuer (internal or external valuer).

For both commercial and residential property, the LTV limit is 60% of the mortgage lending value of the property. This LTV is a relative limit, i.e. when the loan exceeds the 60% limit, the part of the loan up to 60% LTV remains eligible for the cover pool.

V. ASSET - LIABILITY MANAGEMENT

§ 4 PfandBG stipulates that the total volume of Pfandbriefe outstanding must be covered at all times by assets of at least the same amount. Thus, the nominal value of the cover assets must permanently be higher than the respective total value of the Pfandbriefe.

In addition, the Pfandbrief Act requires that Pfandbriefe are covered on a net present value basis even in the event of severe interest rate changes or currency fluctuations. The issuer has to provide an overcollateralisation of at least 2% after stress tests which have to be carried out weekly. Both the maturity of outstanding Pfandbriefe and the fixed-interest periods of the cover pool are disclosed on a quarterly basis. Details about the calculation are regulated in a special statutory order Net Present Value (Barwertverordnung).

Furthermore, each day Pfandbriefbanks have to calculate the maximum liquidity gap within the next 180 days. This amount has to be covered by liquid assets (§ 4 Ia PfandBG).

Every quarter, the stress-tested NPV of outstanding Pfandbriefe, the cover pool and the over-collateralisation have to be published (§ 28 I PfandBG). The stress tests apply not only to interest rate risks but also to foreign exchange risks.

Cash flow mismatch between cover assets and covered bonds is furthermore reduced by the prepayment rules applicable to fixed interest rate mortgage loans. Prepayments of mortgages during fixed rate periods are only permitted in cases of "legitimate interest" of the borrower or after a period of ten years. If the mortgage is prepaid, the borrower has to compensate the damage of the lender caused by the prepayment (§ 490 II German Civil Code).

VI. TRANSPARENCY

According to § 28 of the Pfandbrief Act (Pfandbriefgesetz, PfandBG), all Pfandbrief Banks are obliged to publish detailed information about their Pfandbrief outstanding and the pertaining cover pools on a quarterly basis. These include:

> The total volume of Pfandbrief outstanding as well as the related cover pools in terms of nominal, net present and stressed net present value;
> The share of derivative financial instruments in the cover assets;
> The share of further cover assets;
> The maturity structure of the Pfandbrief and cover assets;
> Information on the size of the cover assets;
> Information on the mortgages by property type/type of use, region and state;
> Information on the claims against the public sector by state and type of issuer;
> Information on the ship mortgages/aircraft registered liens by register country; and
> Information on non-performing cover assets.

The legal transparency requirements are frequently amended in order to increase confidence and security of investors. In 2009, for example, the Pfandbrief Banks pressed for a more detailed disclosure of maturities in order to ensure that investors are better informed about the short and medium-term maturities. The 2010 amendment of the Pfandbrief Act introduced a period of one month after the end of each quarter, in which the quarterly report must be published, except for the fourth quarter, where this period is extended to two months. The forthcoming amendment of the PfandBG will introduce inter alia further transparency requirements and is scheduled for mid-2013.

Beside these legal requirements, the vdp member banks started the vdp Transparency Initiative in 2010. Within the scope of this initiative, transparency reports of vdp member institutions are published

> In a uniform format;
> That can be processed electronically;
> Using a uniform understanding of the legal requirements; and
> On one central website (the vdp's).[1]

Each report is available as a reading version in pdf format and, suitable for further direct processing, in xls (Excel) and csv formats as well. Automatic links to investor data bases are possible. The website offers sorting possibilities for the reports both by reporting date and bank name. All reports are published in English and German language versions. There is a data history available that goes back to 31 December 2008. Hence, the vdp Transparency Initiative provides investors with excellent resources to analyse Pfandbrief cover pools pursuant to their specific needs.

While transparency of cover pools is important for investors, information on covered bonds has to go far beyond cover assets. Another crucial element is transparency regarding the legal structure of covered bonds, which includes information on the legal nature of the cover pool, the segregation of cover assets, the insolvency remoteness of covered bonds, the timely payment in the case of the issuer's insolvency and on the question who actually issues the covered bond. Transparency of these aspects is of utmost importance for investors as covered bonds are designed to survive the issuer's insolvency. The best cover assets will be of no value for the investor if they disappear in the issuer's insolvency estate. The Pfandbrief Act contains detailed regulations of all these aspects, thus ensuring investors a high degree of product transparency.

1 http://www.pfandbrief.de/cms/_internet.nsf/tindex/de_pub_pfandbg.htm

VII. COVER POOL MONITOR AND BANKING SUPERVISION

BaFin carries out the general banking supervision on German Pfandbrief banks.

In addition, BaFin carries out a special supervision on Pfandbrief banks through two dedicated divisions. The "Pfandbriefkompetenzcenter I - Grundsatzfragen" is responsible for all fundamental issues regarding the PfandBG. A second center of competence ("Pfandbriefkompetenzcenter II – Deckungsprüfungen") carries out cover pool audits.

Cover Audits

The cover pools are subject to a special audit conducted usually every two years by the supervisory authority (§ 3 PfandBG). Cover pool audits are performed either by the appropriate specialist section at BaFin itself or by suitable auditors, who are mandated via contract by public tender.

A cover audit is conducted in respect of individual cover pool assets, the observance of matching cover requirements in terms of the nominal and net present value calculation, the proper keeping of the cover registers, and the systems and processes in place with regard to the cover pools.

Audits of individual cover assets seek to ensure that the respective assets were included in cover in accordance with the relevant rules and regulations or that their continued inclusion is in line with requirements. These audits are made on the basis of suitable samples, which BaFin defines with the help of extensive information about the composition of the cover pools. Moreover, the audit may concentrate on particular areas if BaFin wishes to focus on specific countries, currencies or types of property use. More than 100 individual cases are audited, depending on the size and composition of the cover pool. Where the loan files are not stored at a central location, and given that the documentation for one individual property finance transaction can fill several dozen ring binders, this calls for intensive logistical preparations in order to limit the – in practice – customary length of the audit to two to three months.

A system audit entails examining all the Pfandbrief bank's main processes and systems that are directly or indirectly linked to the cover assets and the issued Pfandbriefe. In particular, process documentation, system descriptions and the proper implementation of the relevant methods are scrutinized.

Furthermore, a cover pool monitor (Treuhänder) supervises the cover pool. He is appointed by the BaFin and must possess the expertise and experience necessary to fulfil all duties. A qualification as a certified auditor suggests that the necessary expertise is provided.

The monitor has to ensure that the prescribed cover for the Pfandbriefe exists at all times and that the cover assets are recorded correctly in the cover register, §§ 7, 8 PfandBG. Without his approval, no assets may be removed from the cover pool or new Pfandbriefe been issued. The BaFin has published a specific statutory order on details of the form and the contents of this cover register (Deckungsregisterverordnung – DeckRegV), § 5 III PfandBG.

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

A cover register (Deckungsregister) permits the identification of the cover assets, § 5 PfandBG. The register records the cover assets being used to cover the Pfandbriefe as well as claims under derivatives (§ 5 I 1 PfandBG).

The legal effect of registration is that in the case of insolvency of the issuer, the assets which form part of the cover pool can be identified: All values contained in the register would not be part of the insolvency estate. § 30 I 1 PfandBG now calls them "insolvency-free assets".

While the bank carries out the daily administration of the cover register, it is the cover pool monitor who supervises the required cover und registration in the cover register, § 8 I, II PfandBG. Copies of the cover register shall be transmitted to the supervisory authority on a regular basis.

Asset segregation

The cover pool is a part of the general estate of the bank as long as the issuer is solvent. If insolvency proceedings are launched, by operation of law, the assets recorded in the cover registers are excluded from the insolvency estate (§ 30 I 1 PfandBG). Those assets will not be affected by the launching of the insolvency proceedings (§ 30 I 2 2. HS PfandBG).

After the launching of the insolvency proceedings, a special cover pool administrator (Sachwalter) carries out the administration of the cover assets (§ 30 II 1 PfandBG). Through the appointment of the cover pool administrator by the court, on proposal of the BaFin, the right to manage and dispose of the recorded assets will be transferred to him automatically by law (§ 30 II 2 PfandBG). Regarding cover assets and timely payment of Pfandbriefe, the cover pool administrator represents the Pfandbriefbank (§ 30 II 5, 6 PfandBG). He is allowed to use premises and staff of the Pfandbriefbank (§31 VIII PfandBG).

The cover pool administrator may even be appointed before the insolvency proceedings have been launched (§ 30 V PfandBG).

Impact of insolvency proceedings on covered bonds and derivatives

Covered bonds do not automatically accelerate when the issuing institution is insolvent, but will be repaid at the time of their contractual maturity. The same applies to derivatives which are registered in the cover register and form part of the cover pool. Accordingly, the German master agreements for cover derivatives stipulate that the bankruptcy of the Pfandbrief issuer does not signify a termination event. Article 13 N° 6 DeckregV stipulates that the collateral provided by the derivative counterpart or the Pfandbrief bank has to be registered in the cover register. The consequence of such registration is that the collateral belongs to the insolvency-free assets.

Preferential treatment of covered bond holders

Covered bond holders enjoy preferential treatment as the law stipulates the separation of the cover assets on the one hand and the insolvency estate on the other, § 30 I PfandBG.

The satisfaction of the Pfandbrief creditors is not limited to the cover assets. On the contrary, these creditors also participate in the insolvency proceedings with respect to the Pfandbrief bank's remaining assets.

Only in the case of over-indebtedness or illiquidity of the cover pool, the BaFin may apply for a special insolvency procedure relating to the cover pool and covered bonds (§ 30 VI 2 PfandBG). Insolvency of the cover pool is the only reason, which might trigger acceleration of Pfandbriefe.

Access to liquidity in case of insolvency

Through the appointment of the cover pool administrator, the right to manage and dispose of the recorded assets is transferred to him by law (§ 30 II 2 PfandBG). Thus, the cover pool administrator has first access to the cover assets and collects the cash flows according to their contractual maturity (§ 30 III 2 PfandBG).

No explicit regulation exists with respect to the insolvency remoteness of voluntary over-collateralisation (OC). However, the insolvency administrator may only demand that the over-collateralisation be surrendered to the insolvency estate if those amounts will obviously not be necessary as cover for the respective Pfandbrief category (§ 30 IV 1 PfandBG). The burden of proof that OC will never be necessary for the timely payment of the Pfandbriefe, lays with the insolvency administrator.

The cover pool administrator is entitled to contract loans in order to obtain liquidity. According to § 30 II, 5 PfandBG, the cover pool administrator may carry out legal transactions with regard to the cover pools in so far as this is necessary for an orderly settlement of the cover pools in the interest of the full and timely satisfaction of the Pfandbrief creditors.

Pfandbriefbank with limited business activities

The amendment of the PfandBG 2010 was focused on the legal nature of cover pools in the event of a Pfandbrief bank's insolvency and on the access of a cover pool administrator to liquid funds during difficult times. A cover pool would get automatically the status of a non-insolvent part of the bank of the insolvent Pfandbrief bank. Thus, the cover pool administrator could act as head of a bank in respect of transactions with the Deutsche Bundesbank; he would also be entitled to issue Pfandbriefe.

More precisely, § 2 IV PfandBG stipulates that the banking license will be maintained with respect to the cover pools and the liabilities covered there from until the Pfandbrief liabilities have been fulfilled in their entirety and on time.

A revised version of § 30 PfandBG addressing the ring-fencing of the cover assets from the insolvency estate confirms this new approach by introducing the new heading 'segregation principle' and by referring to the cover assets as 'insolvency-free estates'. Consistently, the amended PfandBG incorporates the term 'Pfandbrief bank with limited business activities'.

Thus, the amendments 2010 ensure that the cover pool administrator acts on behalf of a solvent Pfandbrief bank that is in possession of a license to engage in banking business in general and in Pfandbrief business more specifically, even if the bank itself is insolvent and the general banking license withdrawn. Hence, the Pfandbrief bank with limited business activities is treated as a solvent bank in order to comply with the eligibility criterion "counterparty" for central bank open market operation with the perspective to satisfy its liquidity needs.

Sale and transfer of mortgage assets to other issuers

According to § 32 I PfandBG, the cover pool administrator may transfer all or a part of the assets recorded in the cover register as well as liabilities from Pfandbriefe as a whole to another Pfandbrief bank. This transfer requires the written approval of the supervisory authority.

According to § 35 I PfandBG, the cover pool administrator may also agree with another Pfandbrief bank that the assets recorded in the insolvent Pfandbrief bank's cover register may be managed in a fiduciary capacity by the insolvent Pfandbrief bank's cover pool administrator for the other Pfandbrief bank.

Thus, particular provisions allow for an easy "transfer" of mortgages outside of the common provisions of civil law, e.g. the management in a fiduciary capacity of registered land charges (so called "Buchgrundschulden") and foreign mortgages. Both forms require the written approval of the BaFin.

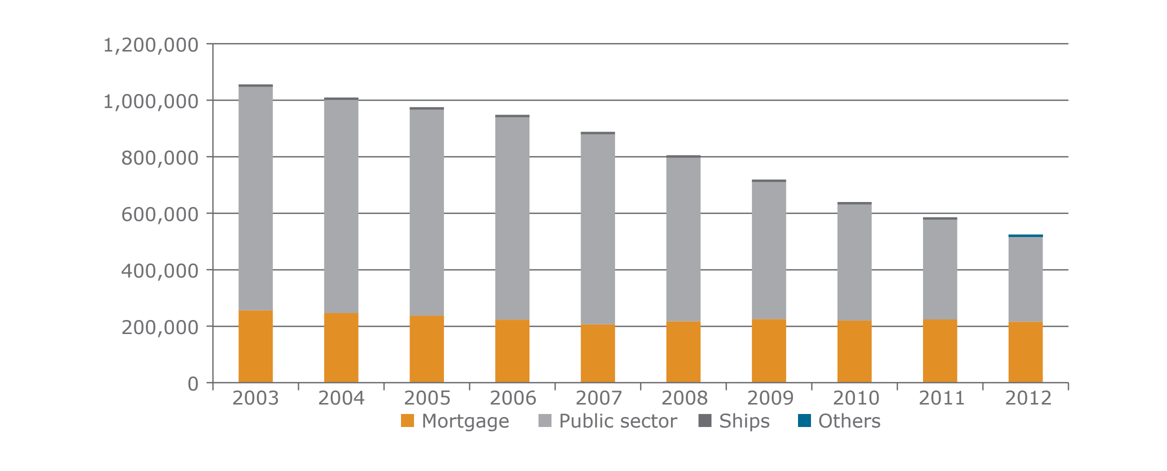
Since 1 January 2011, § 36a PfandBG stipulates that the specific provisions of the PfandBG have priority during the restructuring of a Pfandbriefe issuing institution according to the new "Restrukturierungsgesetz". The amendments 203 clarify a few issues regarding the bridge

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The risk weighting of Covered Bonds (German Pfandbriefe and foreign Covered Bonds) will be regulated by Art. 129 Capital Requirements Regulation (CRR). Thus, German Pfandbriefe as well as foreign Covered Bonds complying with the CRR and carrying an external rating of at least AA- will enjoy a 10% risk weight. Cover pool derivatives will not be receiving a preferential treatment under the new framework any more.

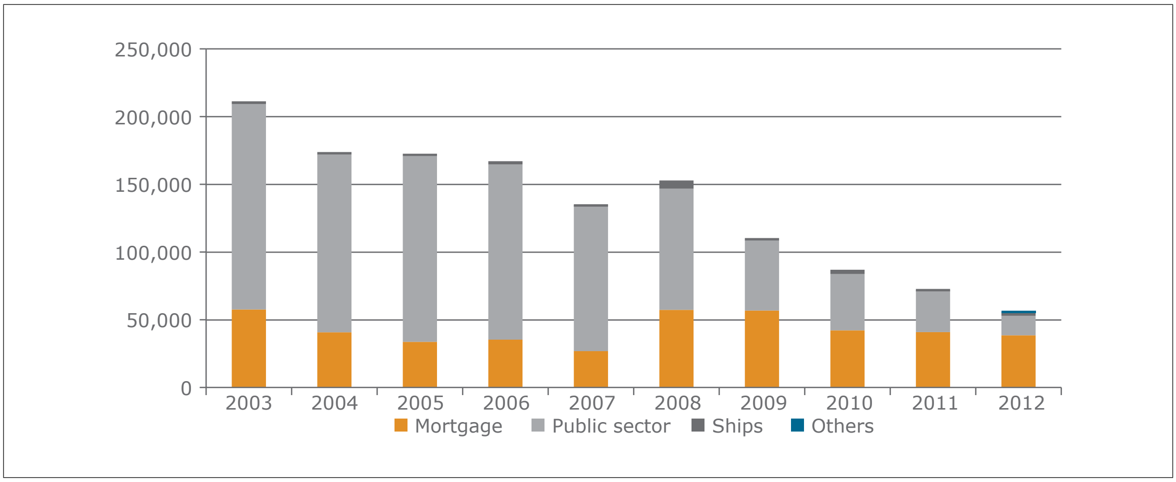
Finally, German investment legislation allows investment funds to invest up to 25% of the fund's assets in Pfandbriefe and furthermore in Covered Bonds issued by credit institutions complying with the requirements of Art. 52 par. 4 UCITS Directive (Article 60 par. 2 German Investment Act).

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2012, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2012, EUR M



Source: EMF/ECBC

Issuers: There are currently about 70 Pfandbrief banks in Germany, including banks from all three pillars of the German banking industry (private banks, public banks and co-operative banks). They include 18 former mortgage banks, 10 Landesbanks and circa 30 savings banks. Also, an increasing number of private universal banks became Pfandbrief banks within the last years.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/23/Pfandbriefe

3.13 GREECE

By Alexander Metallinos, Karatzas & Partners Law Firm

I. FRAMEWORK

In Greece, the primary legal basis for Covered Bond issuance is article 91 of Law 3601/2007 "On the Undertaking and Exercise of Activities by Credit Institutions, Sufficiency of Own Funds of Credit Institutions and Investment Services Undertakings and Other Provisions", which entered into force on 1 August 2007 (the "Primary Legislation"). The Primary Legislation supersedes general provisions of law contained in the Civil Code, the Code of Civil Procedure and the Bankruptcy Code. By way of implementation of the Primary Legislation and, pursuant to an authorization provided by the latter, the Governor of the Bank of Greece has issued Act nr. 2598/2.11.2007, which was replaced by the Bank of Greece Act nr. 2620/28.8.2009 (the "Secondary Legislation"). Finally, the legislative framework in Greece is supplemented by Law 3156/2003 "On Bond Loans, Securitization of Claims and of Claims from Real Estate" (the "Bond Loan and Securitization Law"), to the extent that the Primary Legislation cross-refers to it.

II. STRUCTURE OF THE ISSUER

The Greek legislative framework permits the issuance of covered bonds in two ways, either directly by a credit institution, or indirectly by a subsidiary of a credit institution. In the direct issuance structure the covered bonds are issued by a credit institution and the segregation of the cover pool is achieved through a statutory pledge over the cover pool assets.

By virtue of law 3716/2009, a new paragraph 13 introduced into the Primary Legislation a variation to the direct issuance. Under this structure the covered bonds are issued by the credit institution and are guaranteed by a special purpose entity (SPE), which acquires the cover pool. This structure has not yet been used by any issuer.

In the indirect issuance structure the covered bonds are issued by a special purpose entity being a subsidiary of a credit institution, which purchases the cover assets from the credit institution by virtue of the provisions of the Bond Loan and Securitization Law, and are guaranteed by the credit institution.

The reason for introducing the indirect issuance structure was that historically most Greek banks had issued a significant amount of notes under medium term note (MTN) programmes containing negative pledge covenants, which did not allow the creation of security over the cover pool, as is necessary for the direct issuance of covered bonds. However all Greek banks having MTN programmes have now amended the terms of such programmes to carve out the security provided to holders of covered bonds from the scope of the negative pledge covenants, and therefore the need for the indirect issuance of covered bonds has been removed. In fact, the only indirect issuance of covered bonds has now been fully redeemed and it is to be expected that the regulator will likely not approve any future indirect issue of covered bonds.

III. COVER ASSETS

Cover assets are primarily residential mortgage loans, loans secured by a mortgage on commercial properties, loans secured by a mortgage on ships and loans to or guaranteed by state entities. Residential and commercial mortgage loans may only be included in the cover pool if the property subject to the mortgage is situated in Greece and hence is governed by Greek law. The loans may be secured by mortgage prenotations instead of full mortgages (as is the practice for cost reasons in Greece) provided the credit institution has adequate internal procedures to ensure the timely conversion of mortgage prenotations into mortgages. In addition, openings to credit institutions and investment services undertakings may be included in the cover pool up to an aggregate limit of 15% of the nominal value of the outstanding covered bonds. Derivatives may also be included in the cover pool to the extent that they are used exclusively for the purpose of hedging the interest rate, FX or liquidity risk. To the extent that the counterparties to such derivatives are credit institutions and investment services undertakings (as opposed to state entities or central counterparties in organized markets), the net present value of derivatives included in the pool is included in the above 15% limit. Finally, the cover assets may be substituted by certain tradable assets but only up to the amount by which the aggregate nominal value of the cover assets including accrued interest exceeds the nominal value of the outstanding covered bonds including accrued interest.

IV. VALUATION AND LTV CRITERIA

Loans secured by residential mortgages are required to have a loan to value (LTV) ratio of 80%, whereas loans secured by mortgages over commercial properties and ships are required to have an LTV ratio of 60%. Loans with a higher LTV ratio may be included in the cover pool, but they are taken into account for the calculation of the statutory tests described below only up to the amount indicated by the LTV ratio. Thus, by way of example, a loan of EUR 900,000 secured through a residential mortgage over a property valued at EUR 1,000,000 may be included in the cover pool but will be deemed for the purposes of the calculation of the statutory tests to be equal to EUR 800,000.

The valuation of properties must be performed by an independent valuer at or below the market value and must be repeated every year in relation to commercial properties and every three years in relation to residential properties.

V. ASSET-LIABILITY MAMANGEMENT

The Secondary Legislation provides for tests that are required to be met for the full duration of the covered bonds.

More particularly, the Secondary Legislation provides for the following statutory tests:

(a) The nominal value of the covered bonds including accrued interest may not exceed at any point in time 95% of the nominal value of the cover assets including accrued interest.

(b) The net present value of obligations to holders of covered bonds and other creditors secured by the cover pool may not exceed the net present value of the cover assets including the derivatives used for hedging. This test must be met even under the hypothesis of a parallel movement of the yield curves by 200 basis points.

(c) The amount of interest payable to holders of covered bonds for the next 12 months must not exceed the amount of interest expected to be received from the cover assets over the same period. For the assessment of the fulfilment of this test derivatives entered into for hedging purposes are taken into account.

Tests (b) and (c) are performed on a quarterly basis. In case any of the tests is not met, the credit institution is obliged to immediately take the necessary measures to remedy the situation.

The results of the tests (a) to (c) above and the procedures used to monitor the compliance with such tests are audited on a yearly basis by an auditor independent of the statutory auditors of the credit institution.

The breach of the above mentioned legislation leads to regulatory sanctions. The parties can also agree that the breach of the statutory tests constitutes an event of default.

Moreover, since the Bank of Greece approves each issuance of covered bonds, it would not approve any issuance in case the statutory tests (including the liquidity test) are not met. Therefore a breach of the statutory (but not of any contractual) liquidity test would in practice lead to a Programme freeze. Also the failure to comply with the requirement to restore the statutory tests may lead to sanctions by the Bank of Greece. Apart from the sanctions provided by the Primary and the Secondary Legislation, the contracting parties may agree to additional sanctions, in particular, to alternative administration or an event of default.

VI. TRANSPARENCY

Currently, the issuer's reporting obligations (as in detail described under paragraph on reporting duties of section VII) and the disclosure of the cover pool as conducted via the summary registered with the competent land registry for the establishment statutory pledge (for more details on this issue we cross refer to paragraph on the cover pool monitor of section VII) are the basic transparency tools provided under applicable covered bonds legislation. So far in Greece no market or regulatory initiatives have been undertaken on the creation of a national transparency template, in line with the guidelines of the ECBC Label Initiative.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Cover Pool Monitor

The compliance with statutory tests, mentioned above, is audited by independent auditors. Such audit reports, as well as the quarterly compliance reports by the issuer shall be submitted with the Bank of Greece as regulator.

Prerequisites for the issuance of covered bonds

According to the Primary Legislation, covered bonds may be issued by credit institutions having Greece as home member state. However, in case of issuance of covered bonds by a credit institution having as home state another member state of the European Economic Area (EEA), and provided that they are characterized as covered bonds in accordance with the law of such member state, the provisions of the Primary Legislation on the creation of a statutory pledge will apply in relation to claims governed by Greek law, as well as the tax exemptions which apply to Greek bonds. Therefore, foreign banks established within the EEA having a significant loan portfolio in Greece may use the loans of such portfolio as part of the cover pool.

The Secondary Legislation sets additional prerequisites for the issuance of covered bonds. Specifically the credit institutions issuing covered bonds:

> must have certain minimum risk management and internal control requirements including suitable policies and procedures for the issuance of covered bonds, organizational requirements, IT infrastructure and a policy for the reduction and management of risks deriving from the issuance of covered bonds, such as interest rate risk, counterparty risk, operational risk, FX risk and liquidity risk; and

> must have aggregate regulatory capital of at least EUR 500 m and a capital adequacy ratio of at least 9%.

Reporting duties of the Issuer to the supervisor concerning covered bonds and cover pool

Credit institutions that issue (directly or indirectly) covered bonds shall provide in their financial statements and on their websites information on such covered bonds including on the nominal value and net present value of the bonds and the cover pool and the net present value of derivatives used for hedging.

More particulary, pursuant the Secondary Legislation there are the following disclosure requirements to the Bank of Greece until the end of March of each year in relation to data as of end of December of the year preceding:

> The certified by auditor results arisen following the audit conducted pursuant to the provisions of the Secondary Legislation and following the follow-up of processes and restrictions as set by the Secondary legislation. Any detailed presentation of data, methods and parameters used should also be mentioned.

> Detailed data of the cover pool assets that would confirm the restrictions set under the Secondary Legislation along with the information related to the real estate's revaluation of the mortgages and other loans.

> The following data and information:

a) weighted average interest-rate per category of assets and weighted average interest-rate of all cover pool assets;

b) the real estate values of the mortgages and of the other loans;

c) validation of the selected policy of risk hedging with detailed analysis of the degree of effectiveness of this;

d) table of corresponding maturities of the covered bonds and corresponding assets of the cover pool and the derivatives;

e) Finally all the credit institutions have to communicate to the Bank of Greece, within 30 days from the expiry of each quarter, with data of 1st, 2nd and 3rd quarter end, concise information with regards to the results from the tests provided under the Secondary Legislation.

Banking supervision in crisis

As described in detail under section VIII of this article, the Primary Legislation provides that in case of insolvency of the issuer, the Bank of Greece may appoint an administrator, regardless of the powers they may assign to a special liquidator pursuant to the generally applicable banking special liquidation provisions, if the trustee does not do so.

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

Segregation of cover assets

In case of a direct issuance the cover assets are segregated from the remaining estate of the credit institution through a pledge constituted by operation of law (statutory pledge). In case of assets governed by a foreign law (which will typically include *inter alia* claims from derivative contracts) a security interest must be created in accordance with such foreign law. The statutory pledge and the foreign law security interest secure claims of the holders of covered bonds and may also secure (in accordance with the terms of the covered bonds) other claims connected with the issuance of the covered bonds, such as derivative contracts used for hedging purposes. The statutory pledge and any foreign law security interest is held by a trustee for the account of the secured parties.

The claims constituting cover assets are identified by being listed in a document signed by the issuer and the trustee. A summary of such document is registered in the land registry of the seat of the issuer. Such summary document includes within its content a description of the assets that constitute the cover pool. Claims may be substituted and additional ones may be added to the cover pool through the same procedure.

The Primary Legislation creates an absolute priority of holders of covered bonds and other secured parties over the cover pool. The statutory pledge supersedes the general privileges in favour of certain preferred claims (such as claims of employees, the Greek state and social security organizations) provided for by the Code of Civil Procedure. Furthermore, upon registration of the summary of the document listing the claims included in the cover pool, the issuance of the covered bonds, the establishment of the statutory pledge and the foreign law security interest and the entering into of all contracts connected with the issuance of the covered bonds are not affected by the commencement of any insolvency proceedings against the issuer.

In case of an indirect issuance or a direct issuance guaranteed by an SPE the cover pool assets are segregated from the estate of the credit institution by virtue of their sale to the special purpose entity. For such transfer, the provisions of the Bond Loan and Securitization Law apply, which provide equivalent protection from third party creditors and insolvency to the one the Primary Legislation provides in case of direct issuance.

It is worth noting that according to the Primary Legislation both in case of direct and of indirect issuance the cover assets may not be attached. This has the indirect result that the Greek law claims constituting cover assets are no longer subject to set-off, because according to article 451 of the Greek Civil Code claims which are not subject to attachment are not subject to set-off. This is important because under generally applicable law borrowers the loans to whom become cover assets would have had a right to set-off, which would reduce the value of the cover pool, for all counterclaims (including notably deposits) predating the creation of the pledge or the transfer of the claims, as the case may be.

No specific provisions exist in relation to voluntary overcollateralisation. As a result the segregation applies to all assets of the cover pool, even if their value exceeds the minimum required by law. The remaining creditors of the credit institution will only have access to any remaining assets of the cover pool after the holders of the covered bonds and other creditors secured by the cover pool have been satisfied in full.

Bankruptcy remoteness of and impact of insolvency proceedings on covered bonds

According to the Secondary Legislation covered bonds do not automatically accelerate upon insolvency of the credit institution having issued (in a direct issuance structure) or guaranteed (in an indirect one) the covered bonds.

Pursuant to the Primary Legislation, as amended, the bond loan programme may provide that either from the outset or following the occurrence of certain events, as, indicatively, initiation of insolvency proceedings against the issuer, the trustee will be entitled to assign or undertake the collection and management, in general, of the cover assets by application mutatis mutandis of the Bond Loan and Securitization Law.

Additionally, the Primary Legislation provides that in case of insolvency of the issuer, the Bank of Greece may appoint an administrator, regardless of the powers they may assign to a supervisor or liquidator pursuant to the above articles 63 and 68 of the Primary Legislation, if the trustee does not do so. The proceeds coming both from the collections of the claims that are included in the legal pledge and from the realization of the rest of the assets which are subject to the legal pledge are applied towards the repayment/redemption of the bonds and of the other claims, which are secured by the legal pledge, pursuant to the terms of the bond loan.

The provisions of the Bond Loan and Securitization Law are respectively applied in the sale, transfer, collection and administration, in general, of the assets comprising the cover.

In case of an indirect issuance the obligations of the credit institution under the Guarantee are automatically accelerated in case of bankruptcy by virtue of the generally applicable provisions of bankruptcy law, but this does not lead to automatic prepayment of the covered bonds. To the contrary, the terms of the covered bonds may provide that the proceeds of the Guarantee will be placed in a special account to be used for the servicing of the covered bonds.

Access to liquidity in case of insolvency

The Primary legislation provides that the trustee can be entitled, pursuant to the terms of the programme and the legal relationship connecting the trustee with the bondholders, to sell and transfer the cover assets, and to use the net proceeds of such sale in order to redeem the bonds which are secured by the legal pledge, by way of derogation from articles 1239 and 1254 of the Civil Code.

The above-mentioned sale may occur by virtue of the Bond Loan and Securitization Law or the application of the general applicable provisions

Exercise of the claims of covered bond holders against the remaining assets of the credit institution

The purpose of the Primary Legislation, as was expressly stated in the introductory note to the law, was to ensure that holders of covered bonds would have dual recourse both to the cover pool as secured creditors and to the remaining assets of the credit institution ranking as unsecured and unsubordinated creditors. This was also expressly stated in the Secondary Legislation. Certain doubts which had been raised on this matter by the introduction of the Bankruptcy Code were resolved by an amendment to the Primary Legislation which stated expressly that to the extent that covered bondholders and other secured parties are not fully satisfied from the cover pool, they rank for their remaining claims as unsecured creditors of the issuer.

The programme of the covered bonds may provide that more than one series or issues of bonds may be secured through a single statutory pledge.

The programme may also provide on any other issue related to the priority in satisfaction of the Covered Bondholders and the way they are organized in a group and they are represented, by derogation from the Bond Loan and Securitization Law. Furthermore, the parties may agree to apply a foreign law on these matters.

Protection of depositors

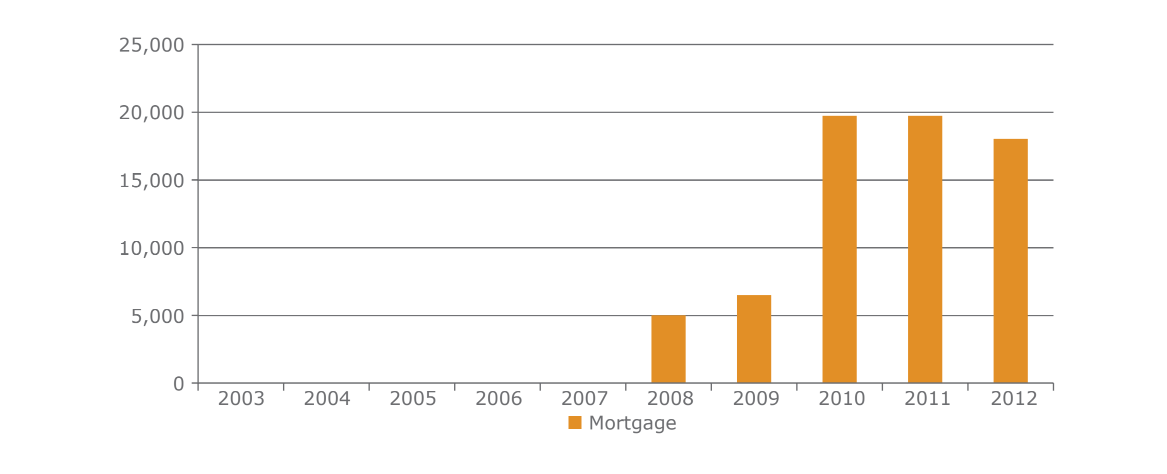
In order to not jeopardize the interests of depositors in case of insolvency of a credit institution due to the segregation (discussed below) of high quality assets in favour for the holders of covered bonds, the Secondary Legislation provides that, in case the cover assets exceed significantly the amount of 20% of the available assets of the credit institution on an unconsolidated basis, the Bank of Greece may impose additional capital adequacy requirements. For the purposes of this calculation available assets are considered to be all assets of the credit institution excluding (i) assets subject to securitization, (ii) assets subject to reverse repo agreements and (iii) assets encumbered in favour of third parties. In exercising its discretion to impose additional capital adequacy requirements the Bank of Greece will take into account qualitative considerations such as (i) any deterioration of the average quality of the remaining available assets after the issuance of covered bonds, (ii) the increase of the liquidity of the credit institution combined and any positive effects it may have on its credit rating and prospects and (iii) the results of additional stress tests.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The risk weighting of covered bonds (both Greek and foreign) is regulated by Part B par. 8 of the Act of Governor of the Bank of Greece No. 2588/20.8.2007, transposing part of the Capital Requirements Directive into Greek law. According to this bonds falling within the provisions of art. 52 par. 4 of the UCITS Directive are considered to constitute covered bonds, provided that the cover pool consists of the assets enumerated in the Capital Requirements Directive. By way of exception, bonds issued before the 31st December 2007 and falling within the provisions of art. 52 par. 4 of the UCITS Directive are considered as covered bonds, even if the cover assets do not comply with the Capital Requirements Directive. Covered bonds have a risk weighting of 10%, if openings to the issuing credit institution have a risk weighting of 20%, and a risk weighting of 20%, if openings to the issuing credit institution have a risk weighting of 50%.

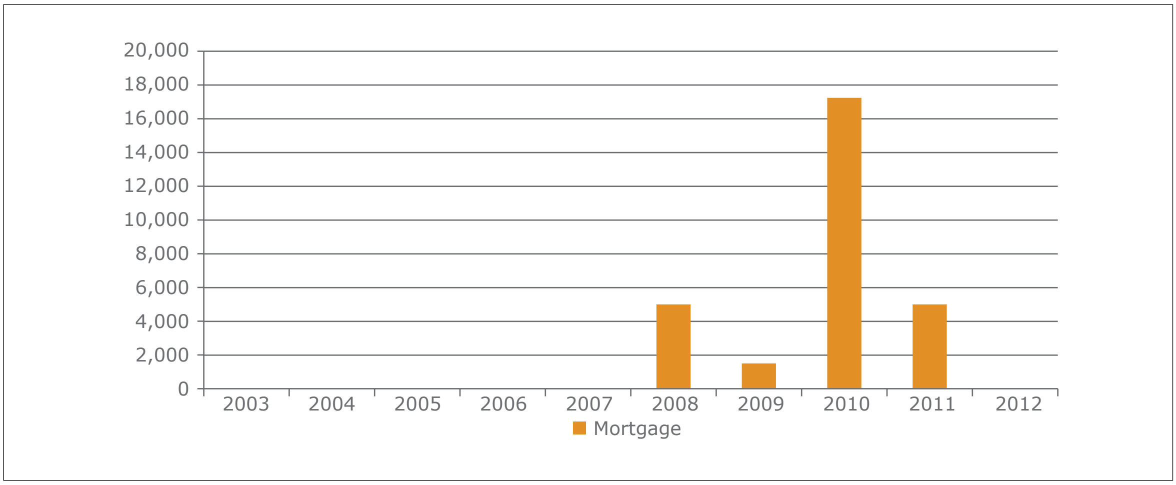
Directly issued Greek covered bonds comply with both the UCITS Directive and the Capital Requirements Directive and, therefore, have the reduced risk weighting mentioned above in Greece and should also have it in other EU member states. In relation to indirectly issued covered bonds it must be noted that they do not fall within the letter of art. 52 par. 4 of the UCITS Directive, because they are not issued by a credit institution.

> Figure 1: Covered Bonds Outstanding, 2003-2012, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2012, EUR m



Source: EMF/ECBC

Issuers: There are five issuers in Greece: Alpha Covered Bond Plc (Indirect Issuance); Alpha Bank (Direct Issuance –2010) - 8billions; Marfin Egnatia Bank S.A. (Direct Issuance); National Bank of Greece; EFG Eurobank Ergasias S.A. (Direct Issuance) 2010 1st Programme 3 billions and 2nd Programme 3 billions; Pireus Bank (Direct Issuance 2011- 3billions)

Issuance Summary
Bonds ISIN Ratings Currency Nominal Value Interest Rate Final Maturity
Series 1 XS0570572460 BBB- (Fitch) EUR 1.250.000.000 1 m Euribor plus 100bp 9 February 2014

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/66/Greek_Covered_Bonds

3.14 HUNGARY

By András Gábor Botos, Association of Hungarian Mortgage Banks

I. LEGAL FRAMEWORK

Act No. XXX of 1997 on Mortgage Banks and Mortgage Bonds (Mortgage Bank Act) contains the specific rules applicable to mortgage banks and mortgage bonds. Act No. CXII of 1996 on Credit Institutions and Financial Enterprises is applicable generally to the establishment, operation, supervision and liquidation of mortgage banks, unless otherwise provided by the Mortgage Bank Act.

II. STRUCTURE OF THE ISSUER

Mortgage banks are specialized credit institutions in Hungary whose business activity is restricted, in principle, to mortgage lending and auxiliary financial services: mortgage banks grant financial loans secured by mortgages – including independent mortgage liens – on real estate property located on the territory of the Republic of Hungary and other EEA countries. Funds will be raised by way of issuing mortgage bonds. In the Hungarian banking sector only mortgage banks are entitled to issue mortgage bonds ("*jelzáloglevél*"). Cover assets will be held on the balance sheet of the mortgage bank. All the mortgage bonds of a single mortgage bank are covered by the same coverage pool which is only open to changes with the prior permission of the coverage supervisor, acting in the interest of mortgage bond holders.

III. COVER ASSETS

The Mortgage Bank Act provides that mortgage banks shall always possess cover surpassing the principal of outstanding mortgage bonds and the interest thereon both on a nominal basis and based on present value calculation. Decree No. 40/2005. (XII. 9.) of the Minister of Finance contains the detailed provisions on the present value calculation of cover assets and the methodology of stress tests to be published on a regular basis. Furthermore, mortgage banks shall prepare a manual of keeping the register of cover assets ("*fedezet-nyilvántartás*"), which also needs the approval of the Hungarian Financial Supervisory Authority (HFSA) and the coverage supervisor.

Loans secured by a residential real estate can be taken in cover up to 70% of the mortgage lending value of the property. In case of loans secured by commercial real estate the limit is 60%.

Mortgage bonds are covered by loans secured by mortgages ("*jelzálogjog*"), independent mortgage liens ("*önálló zálogjog*") or by joint and several surety assumed by the Hungarian State ("*állami készfizető kezes-ségvállalás*"). Supplementary coverage may exclusively consist of liquid assets listed in the Mortgage Bank Act and may not exceed 20% of the coverage. Pursuant to the Mortgage Bank Act, cover assets must be entered into the register of cover. The availability and quality of cover assets is permanently monitored by the coverage supervisor, reports on availability and quality of cover assets are disclosed on a daily basis.

According to Section 14 (5) of the Mortgage Bank Act, in the case when mortgage bonds and their coverage are not denominated in the same currency, the mortgage bank is obligated to hedge the currency exchange risk by entering into derivative transactions. Section 3 (10) of the Mortgage Bank Act provides that mortgage banks are entitled to conclude such transactions exclusively for hedging purposes, i.e. risk management and liquidity. The Mortgage Bank Act entitles mortgage banks to include derivatives in the ordinary coverage as well.

IV. VALUATION AND LTV CRITERIA

The rules of calculation of the mortgage lending value ("*hitelbiztosítéki érték*") are included in the Decree of the Minister of Finance No. 25/1997 on the Calculation Methods of the Mortgage Lending Value of Real Estate not Qualifying as Agricultural Land and the Decree of the Minister of Agriculture No. 54/1997 on the Calculation Methods of the Mortgage Lending Value of Real Estate Qualifying as Agricultural Land. Both decrees prescribe the use of comparative methods, and prescribe the application of the principle of carefulness in the valuation process. Furthermore, they also determine the validity of the valuation report.

Mortgage banks may also provide appraisal services to determine the market value and the mortgage lending value of real properties.

Mortgage lending value calculation provisions refer to the sustainable aspects of the property. The mortgage bank's internal regulation for determining mortgage lending value is based on methodological principles defined in the above decrees. Such internal regulations are also subject to the former approval of the 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% of the amount of the nominal value of the outstanding Mortgage Bonds; and

> The aggregate amount of interest accrued on the outstanding principal claims considered as coverage, reduced by the amount of any value adjustments, shall exceed 100% of the amount of interest accrued on the nominal value of the outstanding mortgage bonds (Section 14 (2) of the Mortgage Bank Act).

Under Section 14 (4) of the Mortgage Bank Act the amount of coverage for mortgage bonds shall always be calculated and published at their present value as well.

Cash flow mismatch between cover assets and cover bonds is furthermore reduced by special prepayment restrictions on the borrowers' side.

VI. TRANSPARENCY

Mortgage banks shall publish the amount of the nominal value and the accrued interest of the outstanding mortgage bonds as well as the value of the coverage assets in a national daily newspaper and in the Exchange Journal as of the last day of each quarter, before the last day of the next month. Such figures need to be certified by the coverage supervisor and disclosed to the HFSA as well.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

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

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

> the existence of eligible security; and

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

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

HFSA. Within the scope of his coverage supervision activities, the coverage supervisor may not be instructed by the mortgage bank.

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

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

Pursuant to the Mortgage Bank Act a cover pool administrator will be delegated to the insolvent mortgage bank to safeguard the interests of bondholders and derivative partners. The cover pool administrator cannot be identical with the insolvency administrator of the mortgage bank. The cover pool administrator should provide for the timely satisfaction of principal and interest claims of bondholders and derivative partners in case of a possible insolvency situation. The cover pool administrator will only safeguard the interests of bondholders and derivative partners and will also have an access to the part of assets not qualifying as coverage and those not recorded in the cover register. The transfer of the portfolio or parts of it to another mortgage bank may grant for liquidity, however, the transfer of the portfolio or parts of it requires the prior written consent of the HFSA.

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.

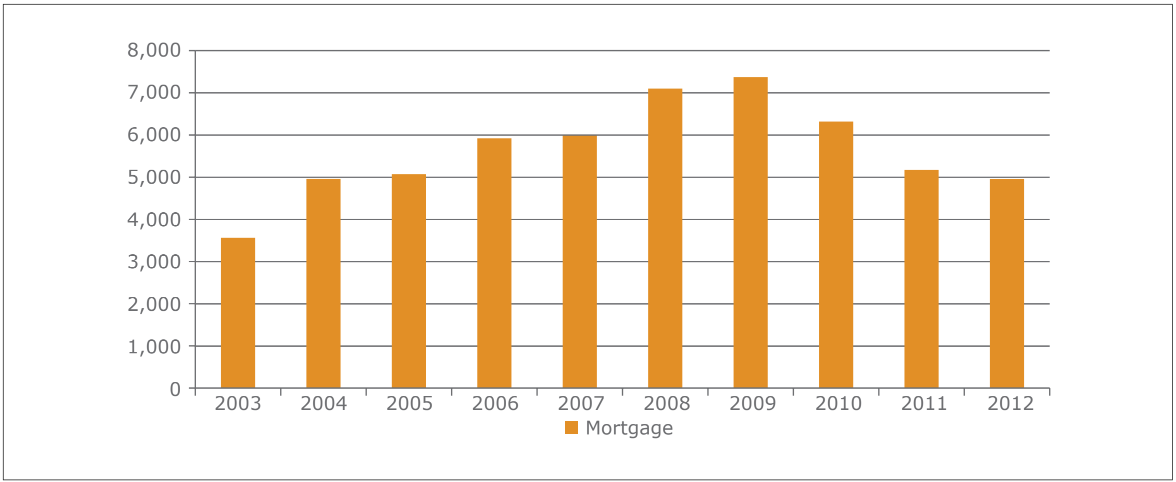
For example, the HFSA is entitled to delegate a supervisory commissioner to the mortgage bank. This extraordinary measurement may be taken by the HFSA prior to the commencement of any insolvency procedure – in accordance with Section 157 (1) of the Credit Institution Act. In this case both the rights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

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Hungarian mortgage bonds comply with the requirements of Art. 52 par. 4 of the UCITS Directive as well as with those of the CRD Directive, Annex VI, Part 1, Paragraph 68 a) to f) as have been reported to the Commission in accordance with Article 63 of the Directive 2000/12/EC and published on its website.

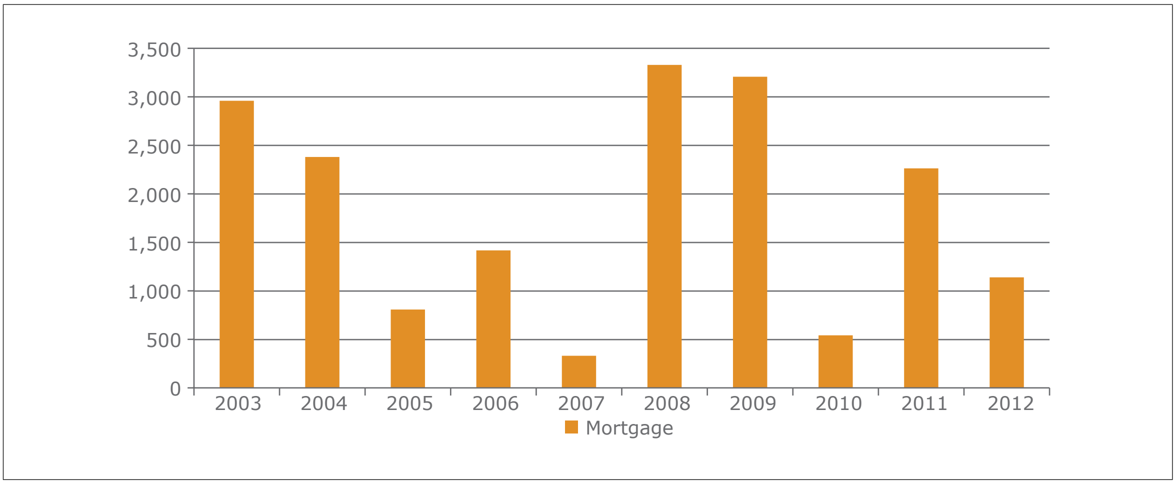
Hungarian covered bonds issued in euro zone countries qualify as ECB eligible; furthermore, in February 2008 one of the Hungarian mortgage banks successfully closed its debut transaction in the "Jumbo" covered bond market.

> Figure 1: Covered Bonds Outstanding, 2003-2012, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2012, EUR m



Source: EMF/ECBC

Issuers: There are three mortgage banks issuing mortgage bonds on the Hungarian market: OTP Jelzálogbank Zrt. (OTP Mortgage Bank Ltd.), FHB Jelzálogbank Nyrt. (FHB Mortgage Bank Ltd.) and UniCredit Jelzálogbank Zrt. (UniCredit Mortgage Bank Ltd).

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/27/Hungarian_Covered_Bonds

3.15 ICELAND

By Eiríkur Magnús Jensson and Kristín Erla Jónsdóttir, Arion Bank

I. FRAMEWORK

In Iceland, the issuance of covered bonds is governed by the Icelandic Covered Bond Act, which came into force on 14 March 2008 (Lög nr. 11/2008 um sértryggð skuldabréf, hereinafter the "ICBA"). The ICBA supersedes the general bankruptcy law and grants covered bond investors a priority claim on eligible cover assets (ICBA: Chapter VII, Article 14). Regulatory provisions no. 528/2008 (Reglur nr. 528/2008, hereinafter the "ICBR") established by the Icelandic Financial Supervisory Authority (Fjármálaeftirlitið, hereinafter the "FME") complement the legislation. These regulations define in more detail the criteria for obtaining a covered bond issuance licence, the universe of eligible cover assets, valuation procedures for eligible cover assets, asset and liability management, and the form and maintenance of the cover register.

II. STRUCTURE OF THE ISSUER

The FME grants licences for the issuance of covered bonds. Licences to issue covered bonds can only be granted to commercial banks, savings banks and credit undertakings. The issuer must meet certain criteria to qualify for the license. These criteria include the submission of a financial plan, confirmed by a public accountant, proving the issuer's financial stability for at least the next three years; a description of the proposed covered bond issuance and how the issuer intends to organise and administrate the covered bond issuance; and the covered bond register as well as written confirmation from the issuer that he and the planned bond issue comply with the ICBA and ICBR. The FME has the right to withdraw the licence should the issuer be in material breach of the ICBA or if the issuer has failed to issue covered bonds within one year of receiving the licence (Figure 1).

> Figure 1: Licence needed to issue covered bonds

Requirements for issuance licence

- Issuer must supply the FME with a board resolution that the board approves the application for a covered bond licence.
- Description of the proposed bond issuance and how the issuer intends to keep and organise the covered bond register.
- Information about the covered bond register, e.g. how the issuer will maintain the register as well as how the register will be supervised.
- The FME can allow an issuer to convert previously issued bonds used to finance assets that are eligible under ICBA into covered bonds.
- The issuer must submit a financial plan, confirmed by a public accountant, proving the issuer's financial stability for at least the next three years; a description of the proposed covered bond issuance and how the issuer intends to organise and administrate the covered bond issuance; and the covered bond register as well as written confirmation from the issuer that he and the planned bond issue comply with the ICBA and ICBR.
- The issuer must submit information about IT systems used in relation to the covered bond issuance.
- The issuer must submit any other information that is relevant for the proposed bond issuance.

The cover assets represent a claim of the covered bond issuer and remain on the balance sheet. There is no subsequent transfer of cover assets to another legal entity. The covered bonds are direct, unconditional obligations on the part of the issuer. Outstanding covered bonds are backed in their entirety by the cover pool. Hence, there is no direct legal link between a single cover asset and a particular covered bond series. In the event of issuer insolvency, the cover pool is bankruptcy remote from the general insolvency estate of the issuer and exclusively available to meet outstanding claims of covered bond investors. It should also be noted that covered bond investors enjoy recourse to the insolvency estate of the issuer, ranking pari passu with senior unsecured investors.

III. COVER ASSETS AND COVER REGISTER

Eligible assets in the covered bond register are mortgage loans and public sector assets (ICBA Chapter II, Article 5). The ICBA does not specify separate cover pools for mortgage and public sector cover assets. Both asset classes can be mixed in one cover pool. Icelandic covered bond issuers have issued covered bonds where the asset register consists exclusively of residential mortgages.

Eligible assets according to ICBA are:

> Mortgages secured by residential housing in member states[1];

> Mortgages secured by industrial, office or commercial property in member states;

> Mortgages secured by farms and other real estate used for agricultural purposes in member states; and

> Public sector assets defined as bonds issued by the Icelandic state or other member state, municipality in Iceland or in another member state, or guaranteed by such member state.

Derivative contracts

The ICBA provides for the use of derivatives for hedging interest and currency risk. The derivatives must be structured such that premature termination is not triggered by an issuer default or a demand by the counterparty. Derivative counterparties must have a rating from rating agency approved by the FME. The minimum is a long-term rating of A3/A-/A- (Moody's/S&P/Fitch) or short-term rating of P2/A2/F2. If the counterparty's rating falls below the minimum level, the issuer of covered bond can:

> Request additional collateral;

> Terminate the derivative contract and open a new contract with a counterparty that meets the minimum rating requirement, or;

> Request that the counterparty provide a guarantee from a third party that meets the minimum rating requirement.

Substitute assets

The ICBA allows for the inclusion of the following substitute assets:

> Demand deposits with a regulated financial firm;

> Deposits with or claims against a member state or central bank in a member state;

> Claims against other legal entities which, in FME's estimation, do not involve greater risk than those referred to in the two points above of this paragraph.

1 Member state: a state which is a party to the Agreement on the European Economic Area or the European Free Trade Association Treaty, or the Faroe Islands.

FME may approve as substitute collateral the following claims:

> Claims against municipalities in member states;

> Claims against a regulated financial firm other than those referred to the point above (of the first paragraph), provided the final maturity is within one year of their issuance;

> Claims against foreign development banks listed in rules adopted by FME;

> Claims against other legal entities which do not involve greater risk than the substitute collateral referred to the three points above of this paragraph.

Substitute collateral may not comprise more than 20% of the value of the cover pool. The FME may authorise an increase in the proportion of substitute collateral in the cover pool to as much as 30% of its value.

IV. VALUATION AND LTV CRITERIA

The ICBA defines valuation principles for properties that act as a collateral for mortgages in the cover pool (ICBA: Chapter III, Article 7). An assessment of the market value of real estate shall be based on the selling price in recent transactions with comparable properties. If the market value of real estate is not available, it shall be determined by a specific valuation. The valuation shall be based on generally accepted principles for market valuation of real estate. Data on real estate price developments from the Land Registry of Iceland of Iceland, for instance, may be used as a basis, together with other systematic collection of real estate price data.

If an issuer assesses the market value of real estate, the independent inspector provided for must verify that the appraisal is based on accepted methodology. The inspector may re-assess the market price of one or more properties if he/she regards the valuation as incorrect.

An appraisal of the market value of real estate must be in writing and must specify what methodology is used, who has carried out the appraisal and when it was made.

For the various mortgage types eligible as cover, the maximum LTV ratios apply (ICBA: Chapter III, Article 7):

> 80% of the value for real estate intended for residential use.

> 70% of the value for real estate intended for agricultural use.

> 60% of the value for real estate intended for office or commercial use.

V. ASSET – LIABILITY MANAGEMENT

The ICBA requires that the nominal value of the cover assets at all times exceed the aggregate nominal value of claims arising from outstanding covered bonds against the issuer (ICBA: Chapter V, Article 11). In addition, the law requires that on a net present value (NPV) basis, cover assets, including derivatives, always exceed the corresponding value of the interest and principal of outstanding covered bonds, taking into account the effects of stress-test scenarios on interest and currency risk set by the FME. The FME defines the stress test for interest-rate risk as a sudden and sustained parallel shift in the reference curve by 100bps up and down. The reference curve is based on Icelandic government bonds for covered bonds in Icelandic krona but swap rate curves for other currencies. Likewise, it defines currency risk as a 10% sudden and sustained change in the relevant foreign exchange rate between the currency of covered bonds and the currency of cover assets (ICBR: Chapter IV, Article 8). The ICBA does not require a mandatory level of minimum overcollateralization (OC). However, the issuer can adhere the to a self-imposed OC level for structural enhancement, as the ICBA protects any OC in the cover pool in the event of issuer insolvency.

Finally, the issuing institution shall ensure that the cash flow with respect to the assets in the cover pool, derivatives agreements and the covered bonds are such that the institution is always able to meet its payment obligations towards holders of covered bonds and counterparties in derivatives agreements (ICBA: Chapter V, Article 11). The issuer should be able to account for these funds separately.

VI. TRANSPARENCY

The issuers are already presenting information regarding their cover pool and outstanding covered bonds on a monthly or at least on quarterly basis. This information is today on the issuer's website.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The covered bond issuers fall under the special supervision of the FME. The financial regulator monitors the institutions' compliance with the ICBA and other related regulatory provisions (e.g. ICBR). If the covered bond issuer is in material breach of its obligation under the legal framework, the FME can issue a warning or revoke the issue license altogether. The FME may also revoke a license if the institution has declared that it waives the license or if the institution has not made use of the license within a year from the date of receiving the license. The revocation may be combined with an injunction against continuing the operations and with the imposition of a conditional fine. In any case, the FME must determine how the operations should be wound up (ICBA: Chapter IX, Articles 24–29).

For each issuing institution, the FME must appoint an independent and suitably qualified cover pool inspector, who is paid by the covered bond issuer. The duties of the cover pool inspector are to monitor the register and verify that covered bonds, derivatives agreements and the cover assets are correctly recorded. The inspector also ensures compliance with matching and market risk limits in accordance with ICBA. The institution is obliged to provide the covered bond inspector with any information requested relating to its covered bond operations. The cover pool monitor must submit a report of the inspection to the FME on an annual basis and must notify the FME as soon as he/she learns about an event deemed to be significant to the supervisory authority (ICBA: Chapter VII, Articles 21–23).

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

Cover register

The issuer must keep a register of eligible cover assets, substitute assets, derivative contracts and outstanding covered bonds (ICBA: Chapter 6, Section 13). The law specifies the form and content of such a register, which must be easily accessible to the FME and the cover pool inspector. The registration legally secures covered bond holders and derivatives counterparties a priority claim on the cover pool in the event of issuer insolvency (ICBA: Chapter 7, Section 14). Prior to an issuer being declared insolvent, cash flows accruing from the cover assets must be accounted for separately by the issuer. In the event of issuer default, covered bond investors and derivative counterparties have the same priority claim on these funds as they have on the cover pool. Moreover, cash flow accruing from the cover assets after issuer insolvency must be registered in the cover pool.

Issuer insolvency

In the event of issuer insolvency, the registered cover assets and the respective covered bonds are segregated from the general insolvency estate. An issuer default does not trigger the premature termination of registered derivative contracts. Covered bond holders and registered derivative counterparties have a priority claim on the cover pool and cash that derives from the pool, ensuring timely repayment to original agreed terms, as long as the pool complies with the ICBA. However, the cover pool does not constitute a separate legal estate.

Cover pool insolvency and preferential treatment

In the event that the cover pool breaches eligibility criteria, covered bonds are accelerated. Covered bond investors and derivative counterparties would have priority claim on the proceeds from the sale of the cover assets, ranking pari passu among themselves. If the proceeds are insufficient to repay all liabilities on outstanding covered bonds, covered bond investors and derivative counterparties have an ultimate recourse to the insolvency estate of the issuer, ranking pari passu with senior unsecured investors.

Survival of OC

Any overcollateralization (OC) present in the cover pool at the time of issuer insolvency is bankruptcy-remote provided it is identified in the cover pool register. Indeed, the CBIA requires full repayment of outstanding claims on covered bonds and registered derivatives before cover assets are available to satisfy claims on unsecured creditors. The law does not provide for the appointment of a special cover pool administrator. The receiver-in-bankruptcy represents the interest of both the covered bond investors and the unsecured investors. The receiver has the right to use OC to pay advance dividends to other creditors of the bankrupt issuer if the pool contains more assets than necessary. If the cover pool assets later prove to be insufficient, these advance dividend payments can be reclaimed.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Icelandic covered bonds comply with the criteria of UCITS 52(4) and with the covered bond criteria defined in the EU CRD Directive, Annex VI, Part 1, Paragraph 68 a) to f). The ICBA explicitly lists mortgages against property for agricultural purposes and mortgages against the pledging of tenant-owner rights as eligible cover assets, while the EU CRD does not. In addition, issuers can impose self-restrictions to ensure that their covered bond issues comply with EU CRD. Icelandic covered bonds are not eligible for repo transaction with the Sedlabanki (the Icelandic Central Bank).

X. ADDITIONAL INFORMATION

Legislative covered bonds in Iceland

Arion Bank and Íslandsbanki were both granted a licence to issue covered bonds under ICBA in the fall of 2011 and both followed up by issuing covered bonds denominated in Icelandic krona to domestic investors. Landsbankinn was granted a licence to issue covered bonds in April 2013 and is aiming for an inaugural covered bond issue soon. The banks use their covered bond programs to fund their residential mortgage portfolios.

A specific attribute of the Icelandic mortgage market is that the majority of Icelandic mortgages are inflation linked. This means that the principal of each mortgage follows the changes in consumer prices in Iceland. This has changed since 2011 when the banks started to offer fixed rate loans that were not tied to inflation. Both Arion Bank and Íslandsbanki have issued inflation linked covered bonds and normal fixed rate covered bonds. Figure 2 shows an overview of covered bonds issued under ICBA. Normally, the bonds are registered at the Nasdaq OMX Iceland (NASDAQ OMX Group) or another European stock exchange.

> Figure 2: Overview of covered bonds issued under ICBA

Issuer	Currency	Inflation linked (Yes/No)	Interest rate	Issue date	Maturity date	Amount outstanding (EUR m)*
Arion Bank	ISK	Yes	3.60%	17.02.2012	21.02.2034	16.3
Arion Bank	ISK	No	6.50%	16.05.2012	16.05.2018	28.4
Íslandsbanki	ISK	Yes	3.50%	07.12.2011	07.11.2016	26.2
Íslandsbanki	ISK	Yes	2.84%	07.03.2012	07.03.2019	28.1
Íslandsbanki	ISK	Yes	3.45%	07.03.2012	07.03.2024	35.6
Íslandsbanki	ISK	No	6.398%	25.10.2012	25.10.2015	11.4

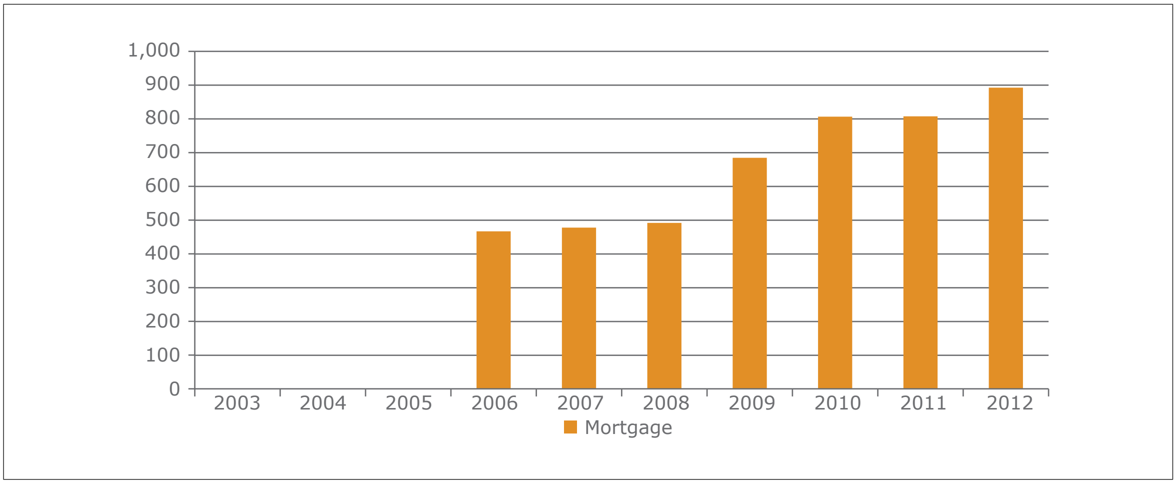
* EUR/ISK exchange rate 152.91 as of 30 April 2013

Covered bonds in Iceland prior to the financial crisis of 2008

The legislation on covered bonds (ICBA) came into force in March 2008 only a few months before the collapse of the Icelandic financial system in October of the same year. Covered bonds based on the legislation had not been issued prior to the crisis of 2008 although one bank had been granted a licence from the FME to issue covered bonds without ever issuing bonds.

Both Glitnir and Kaupthing Bank and other smaller financial institutions set up structured covered bond programs in 2006 and 2007. The bonds issued under these programs were mainly used as collateral in repo transactions with the Central Bank of Iceland and/or other counterparties. A small minority of these bonds was sold to other investors. The holders of the structured covered bonds did not take a loss on their holding despite the bankruptcy proceedings of the issuers. The largest of these structured covered bond programs was the Kaupthing ISK 200 bn covered bond program that was restructured in late 2011 when Arion Bank took over as issuer and acquired the mortgages under the program. The book value of outstanding Arion Bank structured covered bonds is EUR 776 million as of 31 December 2012.

> Figure 1: Covered Bonds Outstanding, 2003-2012, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2012, EUR m

Source: EMF/ECBC

3.16 IRELAND

By Nick Pheifer, DEPFA BANK and Sinéad Gormley, Bank of Ireland

I. FRAMEWORK

Irish covered bonds benefit from the protection of specialist covered bond legislation in the Irish Asset Covered Securities Act 2001 and the Asset Covered Securities (Amendment) Act 2007 (the "ACS Acts") and the regulations and regulatory notices issued thereunder. The framework provides for the issuance of asset covered securities ("ACS") secured on public credits, mortgage credits (each, as defined below) and commercial mortgage credits (being obligations secured on commercial property assets). There is currently no issuer of ACS secured on commercial mortgage credits in the Irish market and, consequently, this chapter focuses on the framework applicable to ACS secured on public credits and mortgage credits.

II. STRUCTURE OF THE ISSUER

An issuer (an "ACS Issuer") of ACS must hold a banking licence and be registered under the ACS Acts as a designated credit institution. It is required to limit the scope of its banking activities to certain permitted business activities. An ACS Issuer is therefore subject to regulation by the Central Bank of Ireland (the "CBI") in its capacity as a bank and separately, in its capacity as an ACS Issuer. Each ACS Issuer will be registered as a designated public credit institution (authorised to issue public credit covered securities) and/or a designated mortgage credit institution (authorised to issue mortgage credit covered securities).

The ACS Issuer holds the assets backing the ACS on its balance sheet. The collection of either mortgage credit assets or public credit assets (the "cover assets") backing the issue of ACS (the "cover pool") is described as dynamic or open in the sense that the ACS Issuer may move cover assets in and out of the cover pool provided that it does so in accordance with the provisions of the ACS Acts. One such control is that the ACS Issuer must maintain a register (a "cover register") of all ACS issued, all cover assets hedge contracts and the cover assets (including any substitution assets and any cover assets constituting over-collateralisation) and any amendment to the cover register can only be effected with the approval of a cover-assets monitor (the "CAM") which is an independent professional third party, or the CBI.

Statutory Preference

The claims of ACS holders are protected by a statutory preference under the ACS Acts. As preferred creditors, upon an ACS Issuer insolvency, ACS holders are entitled to have recourse to the cover assets included in the cover pool ahead of all other creditors of the ACS Issuer other than the super-preferred creditors (i.e. the CAM and NTMA - see further section VIII below) and pari passu with other preferred creditors (such as the pool hedge counterparties – see further section V below). In this way the ACS holders have protection against the general Irish insolvency laws.

Restriction on business activities

The ACS Acts provide that an ACS Issuer may not carry on a business activity other than a permitted business activity as set out in the ACS Acts. Permitted business activities comprise dealing in and holding public credit assets or mortgage credit assets (depending on the type of designation of ACS Issuer) and limited classes of other assets, engaging in activities connected with the financing and refinancing of such assets, entering into certain hedging contracts, holding collateral under cover assets hedge contracts (referred to in the ACS Acts as " hedge collateral") and engaging in other activities which are incidental or ancillary to the foregoing activities. The ACS Acts limit the scope of non-core ACS business that an ACS Issuer can undertake by restricting its dealing in or holding of financial assets that are not otherwise eligible for inclusion in the cover pool to 10% of the total of all the ACS Issuer's assets. There is also a similar 10% limit imposed on the volume of non-cover pool-eligible OECD assets that an ACS Issuer can acquire. In addition, designated mortgage credit institutions must maintain the aggregate prudent loan to value ("LTV") of their overall mortgage books at or below 100%.

III. COVER ASSETS

The classes of assets which are eligible for inclusion in a cover pool are determined by whether the ACS Issuer is a designated public credit institution or a designated mortgage credit institution.

Designated public credit institutions

The classes of asset eligible for inclusion in the cover pool of a designated public credit institution ("public credit assets") are financial obligations (collectively, "public credits"), including obligations given as a guarantor or surety and indirect or contingent obligations, in respect of money borrowed or raised (whether in the form of a security that represents other public credit that is securitised or not) where the obligor is any one of the following:

> central governments, central banks (each, a "Sovereign"), public sector entities, regional governments or local authorities (each, a "Sub-sovereign") in any EEA country;

> Sovereigns in Australia, Canada, Japan, New Zealand, the Swiss Confederation or the USA (each, an "Eligible Non-EEA Country");

> Sub-sovereigns in any Eligible Non-EEA Country; and

> Multilateral development banks or international organisations, in each case which qualify as such for the purposes of the Capital Requirement Directive ("CRD").

Risk weighting and credit worthiness tests apply to the categories of cover assets outside the EEA countries to comply with the CRD Covered Bond eligibility requirements. In particular, any Sovereign or Sub-sovereign entity within an Eligible Non-EEA Country must have an independent credit rating of at least A-/A3 and any Sub-sovereign entity within an Eligible Non-EEA Country must have, in addition, a risk weighting at least equal to that of a financial institution (i.e. 20% or lower). Furthermore, no more than 20% of the total aggregate value of a cover pool can comprise obligations of Sovereigns and Sub-sovereigns in Eligible Non-EEA Countries with credit ratings below AA-/AA3 (but at least A-/A3).

Designated mortgage credit institutions

Those assets eligible for inclusion in the cover pool of a designated mortgage credit institution ("mortgage credit assets") are financial obligations (collectively, "mortgage credits"), including obligations given as a guarantor or surety and indirect or contingent obligations, in respect of money borrowed or raised (whether in the form of a security that represents other mortgage credit that is securitised or not) that are secured by a mortgage, charge, or other security on residential or commercial property that is located in any EEA country or any Eligible Non-EEA Country. This is subject to a concentration limit, for mortgage credit assets secured on commercial property, of 10% of the total prudent market value of all mortgage credit assets and substitution assets in the cover pool. Non-performing mortgage credit assets may not be included in a cover pool. Furthermore, a mortgage credit asset may not be counted as part of a cover pool if a building related to that mortgage credit asset is being or is to be constructed until the building is ready for occupation as a commercial or residential property. A mortgage credit institution may also include securitised mortgage credits in its cover pool subject to certain credit quality and other criteria and a concentration limit of 10% of the aggregate value of the related outstanding ACS. To date, designated mortgage credit institutions have not included securitised mortgage credit assets in their cover pools.

Substitution assets

Substitution assets can be included in any cover pool provided that they comply with applicable CRD requirements and certain other restrictions. Effectively, these are deposits having a minimum credit rating of Step 2 with a limited duration of 100 days with eligible financial institutions.

IV. VALUATION AND LTV CRITERIA

Designated public credit institution

Public credit assets maintained in the cover pool of a designated public credit institution are ascribed a prudent market value equal to 100% of the amount of the related public credit outstanding on the date of valuation.

Designated mortgage credit institution

The maximum prudent LTV levels for mortgage credit assets included in the cover pool of a mortgage credit institution are 75% for mortgage credit assets backed by residential property and 60% for those backed by commercial property. Prudent LTV levels for mortgage credit assets in the cover pool can exceed the 75% threshold, however the balance of the mortgage credit above this threshold is disregarded for valuation purposes. The inclusion in the cover pool of mortgage credit assets secured on commercial property is restricted to 10% of the prudent market value of all mortgage credit assets and substitution assets included in the cover pool at any time. Cover pool data indicates however, that designated mortgage credit institutions have not included assets secured on commercial property in their cover pools to date.

A designated mortgage credit institution is first required to determine the market value of a property asset at the time of origination of the mortgage credit asset secured on it. It is market practice for such property valuations to be conducted by independent valuers. The designated mortgage credit institution is then required to calculate the prudent market value of such property asset at the time of inclusion of the related mortgage credit asset in the cover pool and also at such intervals (at least once per year) as may be specified by the CBI. In addition, a designated mortgage credit institution is required to calculate the prudent market value of mortgage credit assets and securitised mortgage credits included in the cover pool on a quarterly basis, or more frequently if so instructed by the CAM, for the purposes of demonstrating compliance with the asset-liability and over-collateralisation requirements of the ACS Acts. In practice, the prudent market value of relevant property assets is calculated on a quarterly basis also as this calculation forms part of the valuation process for mortgage credit assets.

For these subsequent calculations, the designated mortgage credit institution must apply the house price index published by permanent tsb and/or the house price index published by the Irish Central Statistics Office (depending on the date of origination) to the valuation obtained at origination, with same being verified by the CAM on a monthly basis.

V. ASSET-LIABILITY MANAGEMENT

The ACS Acts include important asset-liability controls to minimise various market risks.

Duration matching: The weighted average term to maturity of a cover pool cannot be less than that of the related ACS.

Over-collateralisation: The prudent market value of the cover pool must be at least 3% greater than the total of the principal amount of the related ACS in issue (see also *Over-collateralisation* below).

Interest matching: The amount of interest payable on cover assets over a 12-month period must not be less than the amount of interest payable on the related ACS over the same 12-month period.

Currency matching: Each cover asset must be denominated, after taking into account the effect of any cover assets hedge contract, in the same currency as the related ACS.

Interest rate risk control: The net present value changes on the balance sheet of an ACS Issuer arising from (i) 100bps upward shift, (ii) 100bps downward shift and (iii) 100bps twist, in the yield curve, must not exceed 10% of the ACS Issuer's total own funds at any time.

Hedge contracts

Hedge contracts are used in the cover pool to minimise risks on interest rates, currency exchange rates, credit or other risks that may adversely affect the ACS Issuer's business activities that relate to an ACS or cover assets. All such hedge contracts are required to be entered on the cover register by the ACS Issuer. Once so entered, pool hedge counterparties rank as preferred creditors, pari passu with the ACS holders, provided they are not in default of their financial obligations under that hedge contract. Upon the insolvency of an ACS Issuer, a hedge contract will remain in place subject to its terms. Any collateral posted under a hedge contract by a pool hedge counterparty must be recorded on a separate register maintained by the ACS Issuer.

Over-collateralisation

The ACS Acts prescribe a minimum over-collateralisation of ACS for designated mortgage credit institutions and designated public credit institutions of 3% calculated on a present value basis. It is also possible for ACS Issuers to commit by contract to higher minimum levels of over-collateralisation and the market practice has been for ACS Issuers to contractually commit to higher levels. The CAM is responsible for monitoring the levels of legislative and contractual over-collateralisation. Upon an ACS Issuer insolvency, ACS holders will benefit from any cover assets which make up the over-collateralisation to the extent of their claims.

VI. TRANSPARENCY

All ACS Issuers are required to make specific disclosures in relation to cover assets included in their cover pools in their annual financial statements.

Designated public credit institutions

A designated public credit institution is required to disclose:

> the geographic location of its public credit assets and the volume and percentage of assets in each such location; and

> details of public credit assets secured on loans to multilateral development banks and international organisations and the volume and percentage of such assets.

Mortgage credit institutions

A mortgage credit institution is required to disclose in respect of the date to which its financial statements are made up, details of:

> the number of mortgage credit assets, with the amounts of principal outstanding in respect of the related credits being broken down by size;

> the geographic location of its mortgage credit assets and the volume and percentage of assets in each such location;

> the number and principal amounts outstanding of non-performing mortgage credit assets;

> whether or not any persons who owed money under mortgage credit assets had, during the immediately preceding financial year (if any), defaulted in making payments in respect of those assets in excess of EUR 1,000 (so as to render them non-performing for the purposes of the ACS Acts) at any time during that year, and if any such persons had defaulted, the number of those assets that were held in the cover pool;

> the number of non-performing mortgage credit assets replaced with other assets;

> the total amount of interest in arrears in respect of mortgage credit assets that has not been written off;

> the total amount of payments of principal repaid and the total amount of interest paid in respect of mortgage credit assets; and

> in relation to any related mortgage credits that are secured on commercial property, the number and the total amounts of principal of those credits that are outstanding.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

One of the key features of the ACS legislation is the rigorous monitoring role undertaken by the CAM. The CAM is appointed by the ACS Issuer with such appointment being approved by the CBI.

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

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

Some of the CAM's principal obligations include: ensuring that the matching requirements of the ACS Acts with respect to the cover assets and the ACS are met; ensuring that the asset eligibility requirements are met; approving any inclusion in or removal from the cover register, of a cover asset, ACS or hedge contract; checking that the level of substitution assets included in the cover pool does not exceed the prescribed percentage; and ensuring that the legislative and contractual levels of over-collateralisation are maintained.

The CBI is given statutory responsibility for supervising ACS Issuers. The CBI may, with the consent of the Minister for Finance, revoke the registration of an ACS Issuer and/or suspend its business if such ACS Issuer breaches any provision of the ACS Acts. In addition, the CBI has wide-ranging powers under the Irish Central Banking legislation to impose significant fines and administrative sanctions on ACS Issuers and/or their senior management for contraventions of the ACS Acts.

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

As noted above under section II, an ACS Issuer holds its cover assets on its balance sheet. However, the cover assets are ring-fenced from the other assets of the ACS Issuer for the benefit of ACS holders by virtue of (i) their being recorded in the cover register, and (ii) a statutory preference created by the ACS Acts.

Segregation: Cover register

Each ACS Issuer must maintain a cover register including the details of its ACS in issue, the cover assets and substitution assets backing its ACS and any cover assets hedge contracts in existence. The cover register is important as a cover asset or a cover assets hedge contract cannot be described as such unless and until it is recorded on the register. Their registration is prima facie evidence of such assets and hedge contracts being included in the cover pool, entitling the ACS holders and pool hedge counterparties to benefit from the insolvency protection specified in the ACS Acts in respect of such assets and hedge contracts. An ACS Issuer may only remove or amend a register entry with the consent of the CAM or the CBI which further safeguards the interests of ACS holders.

Preferential treatment of ACS holders

Once a cover asset has been entered in the cover register, it will remain a cover asset for the benefit of ACS holders and other preferred creditors until the CAM or the CBI has consented to its removal from the cover register and consequently, the cover pool. Cover assets included in a cover pool do not form part of the assets of the ACS

Issuer for the purposes of insolvency until such time as the claims of ACS holders and other preferred creditors under the ACS Acts have been satisfied.

If the claims of the ACS holders (and other preferred creditors, including the pool hedge counterparties) are not fully satisfied from the proceeds of the disposal of the cover assets, such parties are, with respect to the unsatisfied part of their claims, to be regarded as unsecured creditors in the insolvency process.

Impact of insolvency proceedings on ACS and hedge contracts

Upon insolvency of an ACS Issuer, all ACS issued remain outstanding and all cover assets hedge contracts will continue to have effect, subject in each case, to the terms and conditions of the documents under which they were created.

The claims of ACS holders on the cover pool are protected by operation of law. Cover assets and hedge contracts that are included in a cover pool are not liable to interference by a bankruptcy custodian or similar person whether by attachment, sequestration or other form of seizure, or to set-off by any persons, that would otherwise be permitted by law so long as claims secured by the insolvency provisions of the ACS Acts remain unsatisfied. ACS holders have recourse to cover assets ahead of all other non-preferred creditors regardless of whether the claims of such other creditors are preferred under any other enactment or any rule of law and whether those claims are secured or unsecured.

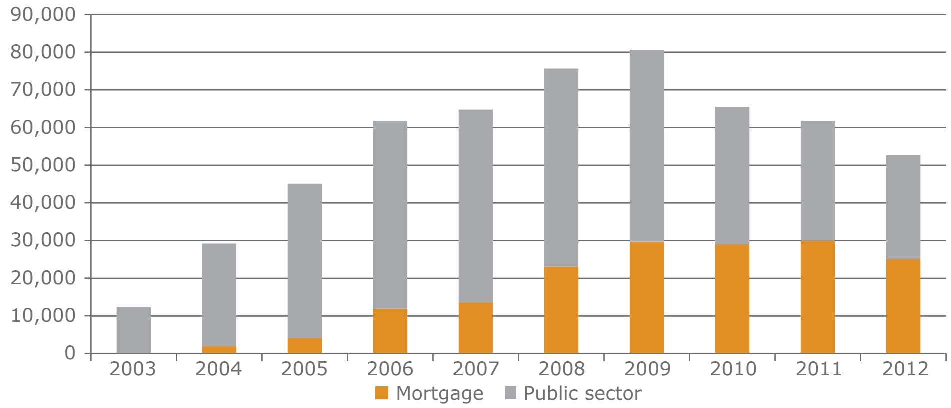
The role of the manager and access to liquidity in case of insolvency

The ACS Acts makes provision for the management of the asset covered securities business of an ACS Issuer upon an ACS Issuer insolvency through the services of the Irish National Treasury Management Agency ("NTMA"). If no suitable manager can be found by the CBI or the NTMA, the NTMA will attempt to locate an appropriate body corporate as a new parent entity for the ACS Issuer. Failing that, the CBI will appoint the NTMA to act as a temporary manager until a suitable manager or new parent entity is found. Upon appointment, a manager will assume control of the cover assets, the asset covered securities business and all related assets of the ACS Issuer. The manager is required to manage the ACS business of the ACS Issuer in the commercial interests of the ACS holders and the pool hedge counterparties. The manager will have such powers as may be designated to it by the CBI under its notice of appointment. It is possible for a manager to obtain a liquidity facility through the use of a hedge contract, such hedge contract if recorded in the cover register would constitute a cover assets hedge contract for the purposes of the ACS Acts and the pool hedge counterparty would rank pari passu with ACS holders and any other pool hedge counterparties.

IX. RISK-WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

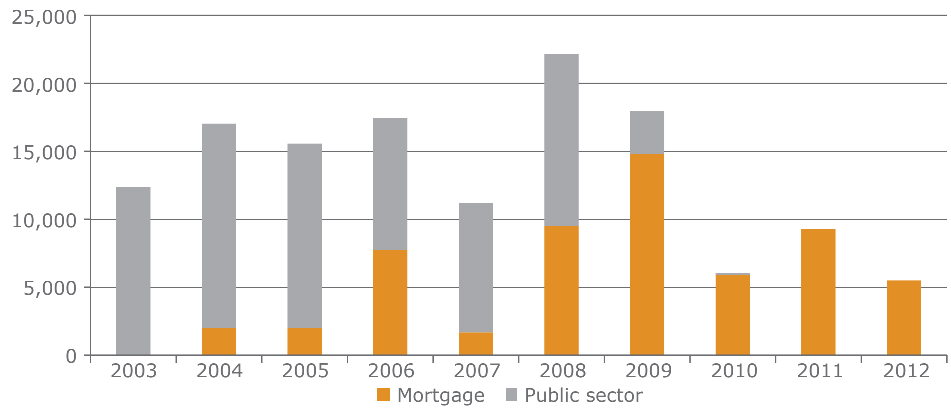
The ACS meet the requirements of UCITS 52(4) and currently benefit from a risk-weighting of 10% as applied by the CBI. The eligibility of cover assets set out in the ACS Acts also match the criteria for the preferential risk weighting of covered bonds set out in the CRD.

> Figure 1: Covered Bonds Outstanding, 2003-2012, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2012, EUR m



Source: EMF/ECBC

Issuers: There are five ACS Issuers with outstanding covered bonds: Bank of Ireland Mortgage Bank, DEPFA ACS BANK, EAA Covered Bond Bank plc, AIB Mortgage Bank and EBS Mortgage Finance.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/28/Asset_Covered_Securities_-_ACS

3.17 ITALY

By Alfredo Varrati, Italian Bankers Association

I. FRAMEWORK

The Italian Legislator enacted a new regulation (Law no. 80/2005) in May 2005, by means of which two specific articles (article 7-*bis* and article 7-*ter*) were inserted into the existing Italian securitization law (Law no. 130/1999), providing for covered bonds.

The legislator decided to supplement Law no. 130/99 rather than adopt a separate and autonomous law/legal framework, in light of the markets' and international operators' positively assessing Italian securitization law. They found that the law introduced an established and reliable legal framework (e.g. from a standpoint of "bankruptcy remoteness").

Pursuant to paragraph 5 of the first of the two articles mentioned above, on 14 December 2006, the Ministry of Economy and Finance issued secondary rules in relation to some key issues of the structure. In particular, implementing rules have been enacted with respect to the type of assets eligible for the cover pool, the maximum allowed ratio between transferred assets and issuable securities, the type of guarantee to be provided to bondholders by the SPV.

As for the last procedural step, which formally allows Italian banks to start issuing covered bonds, the Bank of Italy enacted its implementing measures on 17 May 2007, in relation to the requirements to be complied with by issuing banks, the criteria to be adopted to evaluate the cover assets and the relevant formalities to integrate such assets, as well as the formalities to check that the banks are complying with their obligations under the same article 7-*bis*, also through auditors.

II. STRUCTURE OF THE ISSUE OF COVERED BONDS

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

> 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 the Bank of Italy's regulation, covered bonds can be issued only by banks with the following prerequisites:

> A consolidated regulatory capital not lower than EUR 500 m

> A total capital ratio not lower than 9%

It is also provided that these requisites must be fulfilled by the transferring banks as well (i.e. cover pool providers), if they are not the issuers.

There are no business restrictions to the issuer's activity, hence there is no special banking principle that needs to be enforced. Bondholders hold a preferential claim on the cover assets and the covered bonds are direct, unconditional obligations of the issuer.

III. COVER ASSETS

As provided for by paragraph 1 of Article 7-bis of the securitization law, the eligible assets as coverage for covered bonds are:

> Residential mortgage loans with a maximum LTV of 80% or commercial mortgage loans with a maximum LTV of 60%;

> 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%;

a) Public entities of non-EEA member countries with a risk weight of 0%;

b) Other entities of non-EEA member countries with a risk weight of 20%.

> Notes issued under a securitisation transaction backed (for a minimum of 95%) by the claims under the abovementioned letters a) and b) with a maximum risk weighting of 20%.

As regards the transferring of such eligible assets to the SPV, the Bank of Italy sets different limits according to the different regulatory capital levels of the issuer (see Figure 1)

> FIGURE 1

Regulatory capital level		Transfer limitations
Class A	Total capital ratio ≥ 11% and, Tier 1 ratio ≥ 7%	No limitations
Class B	Total capital ratio ≥ 10% and < 11% and Tier 1 ratio ≥ 6.5%	Eligible assets can be transferred up to 60% of total
Class C	Total capital ratio ≥ 9% and < 10% and Tier 1 ratio ≥ 6%	Eligible assets can be transferred up to 25% of total

As provided for by the secondary legislation enacted by the Italian Ministry of Economy, assets must at least equal liabilities both on the nominal and NPV bases, and the revenues arising from cover assets must be sufficient to pay coupons to bondholders and to cover the cost of derivative transactions.

The integration of cover assets can be performed through:

> The transfer of additional eligible assets to the pool;

> The opening of deposit accounts at banks located in an EEA member country, or in other countries with a 0% risk-weight;

> The transfer of banks' own debt securities (with maturity of less than 1 year) to the pool.

It is also provided that integration through assets under points 2 and 3 is allowed only up to 15% of the cover pool's nominal value. With respect to such provisions, the Bank of Italy established that integration is allowed only to:

> Maintain the ratio of issued bond to cover assets up to the abovementioned level provided for by the Ministry of Economy;

> In case of voluntary over-collateralisation, maintain the ratio of issued bond to cover assets up to the contractually-agreed limit;

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

IV. ASSET-LIABILITY MANAGEMENT

In order to allow the SPV to fulfil its obligations, issuing banks are required to adopt proper asset-liability management techniques and to perform specific controls at least every 6 months, to ensure that the proceeds from the cover pool assets are always sufficient to pay the coupons on the covered bonds, and the overall cost of the transaction.

V. TRANSPARENCY

In 2012, the main Italian OBG issuers, coordinated by the Italian Banking Association, worked together to create a transparency template, consistent with the guidelines of the ECBC Label Initiative. The OBG transparency template is available online on the Covered Bond Label website (https://www.coveredbondlabel.com) and each participating OBG issuer has published a completed version on its own website.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

As far as regulatory supervision is concerned, the Bank of Italy sets and monitors, on an ongoing basis, the abovementioned specific eligibility requirements for issuing banks which are stricter than those provided for traditional banking activities. These parameters require, in particular, a consolidated supervisory capital of at least EUR 500 million and a consolidated total capital ratio of at least 9%. It is also provided that eligible assets may be assigned to the SPV only subject to a series of restrictions, graduated based on the total capital ratio and Tier 1 ratio at the consolidated level.

Although in some European countries the issuance of covered bond is subject to a "licence" granted by the Supervisory Authority upon the fulfilment of specific requirements, the Italian legislator has decided to make a different choice. Rather than introducing a "licence" system, it has defined a series of requirements and limitations to issuance which, together, can be *de facto* considered as the objective basis upon which to grant an issuance authorization. Moreover, it must be considered that such requirements and limitations are in most cases stricter than those required by other regulatory frameworks.

Furthermore, Italian regulation prescribes that the monitoring of the regularity of the transaction and of the integrity of the collateral securing investors must also be performed by an external asset monitor (AM) appointed by the issuer. The AM must be an auditing firm possessing the professional skills required to perform such duties and must be independent from the bank engaging it (e.g. it cannot be the same firm appointed to audit the accounts of the issuing bank) and of any other person participating in the transaction. It has to report at least once a year to the Board of Directors and to the internal audit department of the bank.

Although no specific reporting to the Bank of Italy is prescribed by law, in practice the AM will report to the Supervisor any material anomaly found. It must also be considered that the AM's report is reviewed by the bank's auditor which reports regularly to the Bank of Italy. Should such report contain negative evaluations, the bank's auditor is obligated to bring the issue to the Bank of Italy's attention.

In general terms, specific control requirements on banks issuing covered bonds find their primary source from EU and national legislation. Additionally, in consideration of the peculiarities of a covered bond transaction, the Bank of Italy assigns to issuers the primary responsibility to evaluate the risk involved in the operations, to arrange a proper control mechanism and to ensure its functioning through the time. In particular, at least every six months and for each operation, issuers have to check: i) the quality of the cover pool; ii) compliance with the predetermined ratio between outstanding covered bonds and cover assets; iii) compliance with transfer limitations and asset integration requirements; iv) the performance of any derivative agreement entered into in order to hedge risks.

As far as information flows are concerned, it is provided that issuing/transferring banks shall acquire, from all the parties involved in the structuring of the covered bonds, information relating to:

> The possessory titles of the transferred assets (in order to be able to track down each borrower whose loan has been transferred to the SPV);

> The performance of the transferred assets (in order to monitor the "health" of the cover assets).

This information is necessary to issuing/transferring banks in order to perform both the abovementioned controls in terms of cover pool monitoring and the regulatory reporting (i.e. reporting of defaulted loans to the Bank of Italy's *Centrale dei Rischi*).

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

As provided for by the secondary legislation enacted by the Italian Ministry of Economy, the guarantee granted by the SPV to the covered bondholders, must be irrevocable, first-demand, unconditional and independent from the issuing bank's obligations on the covered bonds. It will be callable upon non-payment and bankruptcy of the issuing bank, and it will be limited to cover pool asset value to ensure bankruptcy remoteness of the SPV.

The SPV is a financial intermediary, registered in the "special list" provided for by article 107 of the Banking Law, and therefore subject to the Bank of Italy's supervision.

Covered bondholders will have the right, represented exclusively by the SPV, to file a claim with the issuing bank for full repayment of the covered bonds. In case of liquidation of the issuing bank, the SPV will be exclusively responsible to make payments to covered bondholders (as well as other counterparties) and will represent covered bondholders in proceedings against the issuing bank.

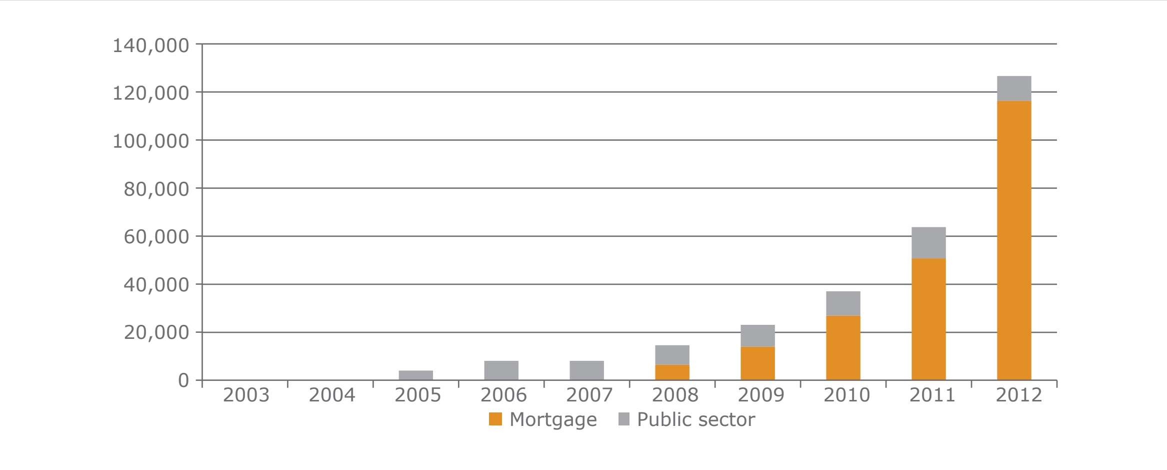
All the amounts obtained as a result of the liquidation procedure will become part of the cover pool and therefore used to satisfy the rights of covered bondholders. The redemption of the subordinated loan granted by the issuer of the covered bonds to the SPV is junior to any outstanding claims of covered bondholders, swap counterparties and transaction costs.

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

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

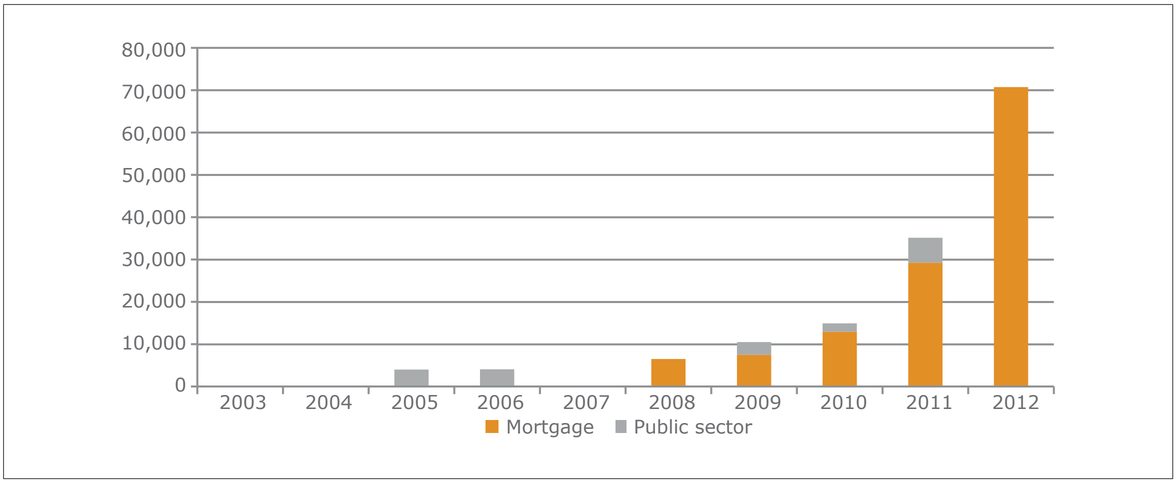
Italian covered bonds fulfil both the criteria of UCITS 52(4) and Annex VI, Part 1, Paragraph 68 (a) to (f) of the Capital Requirements Directive. They are also eligible in repo transactions with the Bank of Italy. The current risk-weight is 20%.

> Figure 1: Covered Bonds Outstanding, 2003-2012, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2012, EUR m



Source: EMF/ECBC

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/31/Obbligazioni_Bancarie_Garantite_-_OBG

3.18 LATVIA

By Kaspars Gibeiko

I. FRAMEWORK

In Latvia, the legal basis for covered bond issuance is the Law on Mortgage Bonds (HKZL – Hipotekāro ķīlu zīmju likums) from 10 September 1998 and subsequent amendments to the HKZL (1 June 2000, 5 July 2001, 6 November 2002 and 25 October 2006). The insolvency and bankruptcy procedure is captured both by the HKZL (Section 4) and the Law on Credit Institutions (Articles 561, 161 and 191).

II. STRUCTURE OF THE ISSUER

There is no specialised banking principle in Latvia. As a result every registered bank can issue mortgage-backed covered bonds. The minimum requirements a bank must fulfil in order to issue mortgage bonds are as follows:

> Tier1 and Tier2 capital should be not less than stated in the Law on Credit Institutions;

> Provision of the banking services specified in Article 1, Clause 4 of the Law on Credit Institutions without any restrictions imposed by the Financial and Capital Market Commission (FCMC);

> Submission of rules approved by the bank's supervisory board regarding the valuation of the real estate to be mortgaged and the management of the mortgage bond cover register to the FCMC.

The issuer holds the cover assets on his balance sheet and the cover assets are not transferred to a different legal entity. All obligations from mortgage bonds are obligations of the issuing bank as a whole, to be paid from all the cover assets of the issuer. In the case of insolvency, the cover pool is segregated by law from the general insolvency estate and is reserved for the claims of the mortgage bond holders.

The HKZL does not prescribe the issuing bank to have separate employees to manage the cover pool, but it prescribes that the cover assets are managed separately from other assets of the issuer. Therefore, if employees of the bank are involved both in the management of the cover assets and the management of non-cover assets, separation of the duties and responsibilities should be clearly stipulated in the bank's by-laws and internal procedures. There are also no specific requirements regarding the outsourcing of the management of cover assets in the Latvian covered bond legislation.

III. COVER ASSETS

Cover assets can be eligible mortgage loans or loans secured by either guarantees of the Latvian Government or guarantees of the local governments.

Up to 20% of the nominal volume of outstanding mortgage bonds and interest expenses (substitute cover) may consist of:

> Cash;

> Balances with the central banks of the EU member states; and

> Securities issued and guaranteed by the EU member state governments up to 95% of their market value whilst not exceeding the face value of these securities or securities issued by the EU member state's financial institution and traded on the EU regulated securities market up to 95% of their market value whilst not exceeding the face value of these securities.

The eligible mortgage assets are restricted in geographical scope to the extent that a property that secures a mortgage loan should be registered with the EU member state's property register. This means that only properties which are registered in the EU member state can be used as collateral for mortgage loans included in the cover pool. The loans secured by Latvian sovereign and sub-sovereign guarantees are not restricted by geographical scope, but they are restricted by loan purpose; loans which finance public and infrastructure projects are eligible.

Derivatives are eligible for cover pool inclusion for the purpose of mitigating currency - and interest rate risk. The volume of derivatives is not limited and the general documentation used is the standard for derivatives.

IV. VALUATION AND LTV CRITERIA

Property valuation is regulated in Article 15 of the HKZL. Property valuation is carried out according to the international valuation standards. The basis for property valuation is market value. Professionals responsible for the determination of the market value of a property must be in possession of a relevant professional qualification. In addition to that, Article 151 (introduced by the amendment to the HKZL on 25th of October 2006) stipulates that the market value of property registered in the EU member state is determined by the persons who have received professional, real estate valuation, licence according to the legislation of particular EU member state.

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

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

V. ASSET - LIABILITY MANAGEMENT

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

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

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

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

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

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

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

VI. COVER POOL MONITOR AND BANKING SUPERVISION

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

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

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

> The issuing bank does not comply with the conditions laid down in the Law on Mortgage Bonds;

> The issuer does not ensure that the redemption and interest payments on outstanding mortgage bonds are always covered by the principal and interest payments of the cover assets of a higher value;

> By-laws on the valuation of properties securing the mortgage assets and by-laws on the management of cover pool submitted to the FCMC are not followed.

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

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

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

Asset segregation

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

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

Impact of insolvency proceedings on covered bonds and derivatives

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

Preferential treatment of covered bond holders

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

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

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

Access to liquidity in case of insolvency

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

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

> Disbursements to mortgage bond holders if the term for interest payments or mortgage bond redemption has become due

> Purchase of mortgage bonds issued by the issuer itself with their subsequent redemption in the public securities market at a price not exceeding the face value of the mortgage bonds if the remaining cover assets are sufficient to cover outstanding mortgage bonds

> Payments under derivatives' agreements concluded on the cover asset risk mitigation, provided that the contracting parties have met the conditions of such agreements.

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

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

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

Sale and transfer of mortgage assets to other issuers

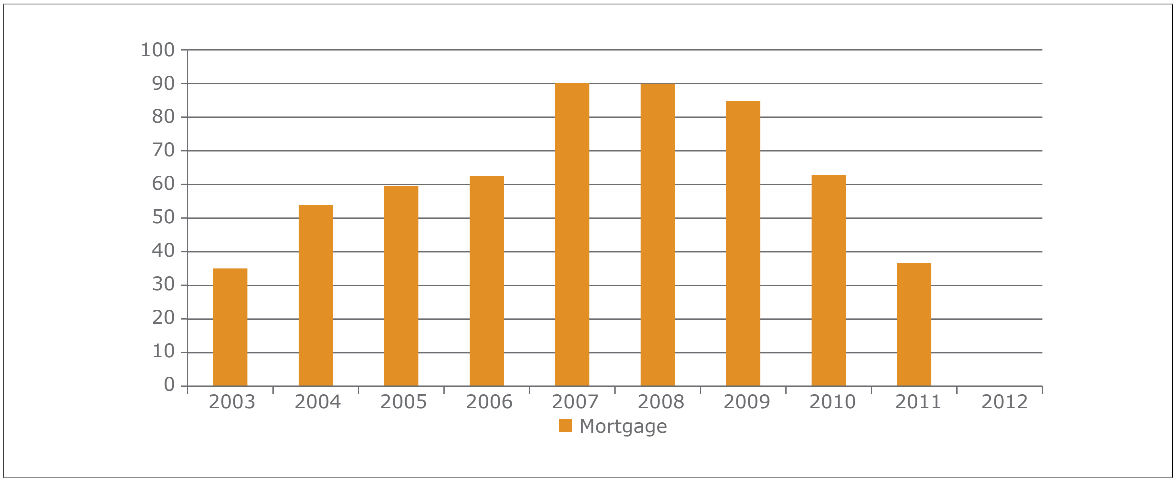
The HKZL and the Law on Credit Institutions provide that the cover assets in a case of insolvency of issuer are transferred to other bank chosen by the FCMC. The bank to which the cover assets are transferred, also takes responsibility for all the obligations arising from outstanding mortgage bonds.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Latvian mortgage bonds comply with the requirements of Art. 52 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%.

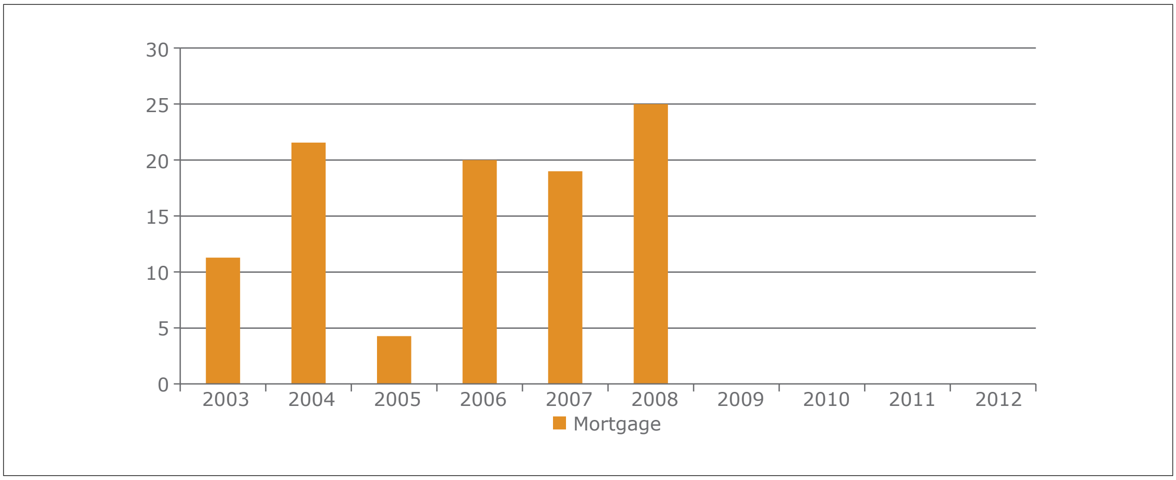
Latvian investment legislation allows mutual funds to invest up to 25% of their assets in mortgage bonds and pension funds – up to 10% of their assets.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2012, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2012, EUR M



Source: EMF/ECBC

3.19 LUXEMBOURG

By Frank Will, RBS, Reinolf Dibus, Hypothekenbank Frankfurt International S.A.and
Dr. Anette Lühring-Ryder, Hypothekenbank Frankfurt International S.A.

I. FRAMEWORK

The issuance of Lettres de Gage is regulated by Articles 12-1 to 12-12 of the Financial Sector Act of 5 April 1993 (the Financial Sector Act). These Articles were introduced by the Act of 21 November 1997 for banks issuing mortgage bonds and amended by the Act of 22 June 2000, by the Act of 24 October 2008 and by the Act of 27 June 2013. The Lettres de Gage regulations are supplemented by the *Commission de Surveillance du Secteur Financier* (CSSF) Circular 01/42 which lays down the rules for the appraisal of real estate and CSSF Circular 03/95 which defines the minimum requirements for the maintenance and control of the cover register, for the cover assets and for the issuance limit for outstanding Lettres de Gage. The CSSF is the supervisory authority in Luxembourg.

The amendments introduced in June 2013 are as follows:

> Part 1 Chapter 1 Section 3 on Lettres de Gage in the law on the Financial Sector act has been completely replaced by a new version. Articles have been restructured, amended and added.

> The geographical scope for asset acquisition is now worldwide but with requirements according to credit quality steps for countries outside the EU, EEA and OECD.

> The Luxembourg issuers are now allowed to issue Lettres de Gage Mutuelles backed by a system of institutional guarantee.

> The rating of eligible securitizations now refers to rating agencies on the list established by ESMA, no longer to S&P, Moody's and Fitch.

> An explicit definition of public enterprise, which was formerly the accepted interpretation of this term, is now mentioned in the law.

> It is explicitly stipulated as a clarification that the cover assets have to be the property of the bank.

> There is now a legal obligation for the issuers to publish information on the cover pools, the lettres de gage and the issuers.

The bankruptcy regulations have also been completely revised. If the court declares open one of the procedures provided for in the law on the financial sector, i.e. suspension of payments or compulsory liquidation, this decision entails the separation of the bank into the cover pools and the additional activities. The cover pools with their corresponding bonds and their corresponding reserve with the central bank continue as proprietary compartments of a mortgage bank with limited activity. This bank still holds a banking licence. The court can also open a procedure of suspension of payments or compulsory liquidation for a cover pool, but this does not affect the other cover pools.

The CSSF is no longer administrator of cover pools in the case of bankruptcy of the Lettres de Gage bank but one or several administrators nominated by the court.

II. STRUCTURE OF THE ISSUER

The Lettres de Gage issuers have to be credit institutions with a specialist bank licence. Their business activities are restricted: In the past, the bank's principal activities were limited to mortgage lending, public sector financing, and lending guaranteed by movable assets which were primarily funded by issuing Lettres de Gage Hypothécaires, Lettres de Gage Publiques and Lettres de Gage Mobilières. Lettres de gage Mobilières were introduced in the amendment in October 2008. According to the last covered bond law amendments in 2013, the Luxembourg issuers are also allowed to issue Lettres de Gage backed by institutional guarantees (Lettres de Gage Mutuelles). They can grant loans to credit institutions in the EU, the EEA and the OECD or loans that are guaranteed by them, on the condition that these credit institutions belong to a system of institutional guarantee. This system has to be recognized by a supervisory authority and guarantee to support its members in the case of economic difficulties.

The issuers may only engage in other banking and financial activities if these activities are accessory and auxiliary to their main business.

The issuer holds the cover assets on its balance sheet in separate registers. Each class of Lettres de Gage has its own register: one for assets which are allocated to the Lettres de Gage Hypothécaires, another one for the cover assets backing the Lettres de Gage Publiques, potentially several more for the various forms of Lettres de Gage Mobilières and one for the cover assets backing Lettres de Gage Mutuelles. The cover assets remain on the balance sheet of the issuer. They are not transferred to another legal entity (special purpose vehicle) like in a securitization. All obligations arising from Lettres de Gage are direct, unconditional obligations of the issuer. In the case of issuer insolvency, the cover pools are segregated by law from the general insolvency estate and are reserved for the claims of the Lettres de Gage holders. There is no direct legal link between a single asset in the cover pool and an outstanding Lettre de Gage. Interest and principal payments of the outstanding Lettres de Gage Hypothécaires, Lettres de Gage Publiques, the various forms of Lettres de Gage Mobilières and the Lettres de Gage Mutuelles are backed by the assets in the respective cover pools.

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

III. COVER ASSETS

The eligible cover pool assets are defined in Article 12-1 of the Financial Sector Act of 5 April 1993. Since the amendments of the covered bond legislation in June 2013, there are four asset classes: mortgage assets, public sector exposures, movable assets, i.e. mortgage loans on ships, aircrafts, trains or other classes of movable assets, and assets backed by a system of institutional guarantee. There is only one regional limitation in place. Credit institutions that are members of a system of institutional guarantee have to be established in a member state of the EU, EEA or OECD. For all other cover assets the restriction to this region has been abolished. In return, a criterion regarding the credit quality of the assets has been introduced. The respective cover pools can contain 50% assets from outside the EU, EEA and OECD, if a rating agency registered on the list at ESMA grants a rating of the first credit quality step to these assets, and 10%, if the rating is of the second credit quality step.

In each of the various cover pools the assets may be replaced by up to 20 % of the nominal value of the outstanding Lettres de Gage by substitution assets, for example cash, assets with central banks or with credit institutions or bonds satisfying the conditions set out in article 43 (4) of the law of 17 December 2010 concerning undertakings for collective investments.

It is also possible to hold the cover assets indirectly through a third-party bank.

The Lettres de Gage Mobilières are backed by movable assets, i.e. mortgage loans on ships, aircrafts, trains or other classes of movable assets. In order to be cover pool eligible, the movable assets and the charges on the property of those assets need to be registered in a public register.

In addition, securitised assets are cover pool eligible if they comply with the eligibility criteria laid down for the various types of Lettres de Gage. The amount of securitised assets that are not cover pool eligible per se will be limited to 10% of the collateral pool. This can be achieved in two ways: One option would be that at least 90% of the assets of each securitisation (vehicle) are cover pool eligible. The other option would be that at least 50% of the assets of each securitisation (vehicle) are cover pool eligible. In that case, the percentage of securitisation assets shall not exceed 20% of the total collateral pool. The issuer can choose one of the two options for each type of Lettre de Gage but cannot combine the two options. Moreover, the securitisation tranches should have a rating of the first credit quality step by a rating agency that is registered on the list by ESMA. The law allows only true sale transactions and synthetic securitisations are explicitly excluded.

Any kind of obligation from public sector institutions including public private partnerships (providing a controlling public sector stake; other public private partnership structures are subject to the above mentioned 10% limit) are cover pool eligible.

There is no limitation on the volume and the types of derivatives used as long as they are employed as hedging instruments.

The cover pools are dynamic. Assets can be included, excluded and exchanged as long as the requirements of the law are not breached.

There is an explicit transparency requirement. The issuers have to publish information on the composition of the cover pool, the bonds and the issuers. The details of which are defined by the CSSF.

IV. VALUATION AND LTV CRITERIA

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

The LTV limit for residential property is 80% of the estimated realisation value. The LTV ratio is 60% for all other immovable and movable properties including commercial real estate loans. The actual loan, however, can exceed the 60% limit (or 80% limit in case of residential mortgages). In those cases, only the first 60% (80%, respectively) of the mortgage lending value is eligible for the cover pool.

V. ASSET - LIABILITY MANAGEMENT

There is a minimum overcollateralisation level of 2% on a nominal basis as well as on a net present value basis. The Luxembourg regulator has the right to review and adjust these overcollateralisation levels. Any mismatches in terms of currency or interest rate risk have to be hedged and the respective hedge instruments have to be included in the collateral pool. In addition, there are the requirements imposed by the rating agencies.

The special auditor has to ensure that there is always sufficient collateral in the pool. This has to be certified by the special auditor when Lettres de Gage are issued. Cover assets may only be removed from the cover pool when the prior written consent of the special auditor has been received and provided that the remaining cover assets are sufficient to guarantee the legally protected cover.

The calculation of the nominal value and of the net present value of the collateral pool as well of the outstanding Lettres de Gage volume must be reported to the supervisory authority on a monthly basis.

VI. TRANSPARENCY

There is an explicit transparency requirement. The issuers have to publish information on the composition of the cover pool, the lettres de gage and the issuer. The details of which will be defined by the CSSF. This is in line with the ECBC Label Initiative.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The supervisory authority of covered bond issuers is the CSSF, as already mentioned above. The CSSF has a specialised department which is responsible for supervising the Lettres de Gage issuers. It is entitled to demand relevant reports and intercede if liquidity problems have been identified at a bank.

The CSSF is also responsible for the approval of the various types of covered bonds secured by movable assets. Definitions, the details on which types of movable assets qualify and other practical issues will be clarified in a separate CSSF Circular.

For the independent control of the cover pool a special auditor which is recommended by the Lettres de Gage issuer has to be approved by the supervisory authority. Only auditing firms which satisfy the conditions set forth in the law of 2009 regarding *réviseurs d'entreprises* (independent auditors) can be appointed as special auditors. The issuer communicates the names of the partners of these auditing firms who will fulfil the function to CSSF. The special auditor must have a suitable qualification and must be able to call upon the experience and technical expertise of a recognized international auditing firm.

The special auditor is continuously responsible for monitoring the collateral pool and the outstanding Lettres de Gage. The auditor must ensure that there are sufficient assets in the collateral pool to service the obligations resulting from the outstanding Lettres de Gage up to the final maturity of the last outstanding bond. The auditor is obliged to inform the supervisory authority immediately, should any of the prudential limits be violated. The Lettres de Gage issuer is also obliged to immediately inform the supervisory authority of the violation of any limits.

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

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

The cover registers for mortgage, public sector and moveable assets and assets backed by a system of institutional guarantee include all necessary data to identify the assets and the derivatives included. As soon as an asset or derivative product is registered in the official cover register it forms part of the collateral pool.

The cover register is managed by the issuer but regularly monitored by the special auditor. The special auditor is obliged to inform the CSSF of any irregularities and provide an annual report.

Asset segregation

In the case that a procedure of suspension of payments or compulsory liquidation is opened for a Lettres de Gage issuer, the assets and derivatives in the collateral pool are separated from the other assets and liabilities of the bank. The respective collateral pools remain unchanged and continue with their corresponding Lettres de Gage and their corresponding reserve at the Luxembourgish Central Bank as proprietary compartments of a Lettres de Gage bank with limited activity. The cover pools do not become separate legal entities. The legal entity of the bank remains unchanged. The banking license continues for the bank with limited activity in order to achieve the purpose of administering the cover pool up to the final maturity of the last outstanding Lettre de Gage. The court nominates one or several administrators for the cover pools. This administrator is different from the general bankruptcy administrator. If a procedure of suspension of payments or compulsory liquidation is opened for one cover pool, the other pools are not affected by this decision and continue.

Impact of insolvency proceedings on Lettres de Gage and derivatives

Lettres de Gage do not automatically become due when a procedure of suspension of payments or compulsory liquidation is opened for the issuing bank. Interest and principal are paid as per their original due dates. The same applies to derivatives registered in the cover register which are part of the cover pool. The net present value of the derivatives after netting ranks pari passu with the claims of the Lettres de Gage holders.

Preferential treatment of Covered Bond holders

Lettres de Gage holders benefit from a preferential treatment in case of an issuer insolvency. The registration of the cover assets in the cover register provides the Lettres de Gage holders with a preferential right, above all other rights, preferences and priorities of any nature whatsoever, including those of the Treasury. But the salary of the administrator and the other fees that are necessary for continuing the bank with limited activity rank first before the claims of the Lettres de Gage holders and the derivative counterparties, which rank pari passu. The general bankruptcy administrator has no direct access to the assets in the collateral pool.

Access to liquidity in case of insolvency

The administrator nominated by the court administers the cash flows resulting from the cover assets and according to the Article 12-10 (5). The administrator can issue lettres de gage for the account of the lettres de gage bank with limited activity. He or she can approach the Luxembourgish Central Bank for liquidity, where the conditions to be fulfilled as a counterparty for transactions within the framework of monetary politics depend on the Eurosystem.

The administrator can transfer the administration of the cover assets and the Lettres de Gage to another bank.

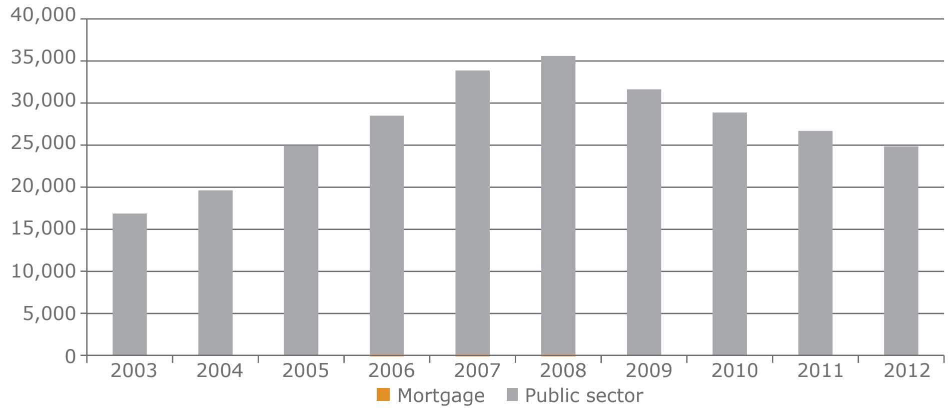
There is no explicit provision in the law regarding any voluntary overcollateralisation. But the overcollateralisation in a cover pool serves to pay for the expenses for the continuation of the bank with limited activity as well as absorb losses.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The Luxembourg Covered Bond legislation fulfils the criteria of Article 52 (4) of the UCITS Directive (Council Directive of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)). In its current format, the Lettres de Gage legislation does not fulfil the requirements set out in Annex VI, Part 1, Article 68 a) to f) of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), the Capital Requirements Directive (CRD). The last two amendments of the Luxembourg covered bond legislation did not make the Lettres de Gage legislation CRD-compliant. However, it should be possible for issuers to make their outstanding Lettres de Gage "CRD compliant" by limiting their cover pool exposure. In January 2014, the current version of the CRD will be replaced by a directive and a regulation that will implement the Basel III rules into European law: Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, the Capital Requirements Directive (CRD), and Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, the Capital Requirements Regulation (CRR). The relevant article with the requirements for covered bonds will be article 129 of the CRR. The current version of the Lettres de Gage legislation does not fulfill the requirements of Article 129 of the CRR either, but the issuers will be able to limit their cover pool exposure the way they can to it now to make their outstanding Lettres de Gage "CRR compliant" in the future.

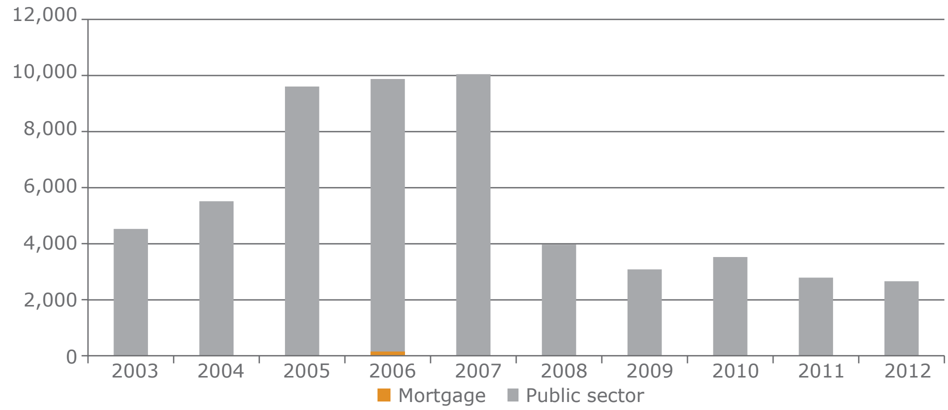
Lettres de Gage are principally eligible for repo transactions with the European central bank. However, on 28 November 2012, the ECB announced amendments of its eligibility criteria for its repo transactions. The changes entered into force on 3 January 2013. Covered bonds with external, non-intra group securitisations in the cover pool are no longer eligible as collateral for repo transactions as of 31 March 2013. To smooth the impact for existing programmes, the ECB granted a grandfathering period of two years until 28 November 2014 for already issued covered bonds. This means that new covered bonds with external RMBS or other ABS (both group-internal or external) in the cover pool are no longer repo eligible from the end of March 2013 although tap issues of grandfathered covered bonds will remain eligible during the grandfathering period, as long as no additional external RMBS or other ABS are added to the cover pool.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2012, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2012, EUR M



Source: EMF/ECBC

Issuers: There are six issuers in Luxembourg: Dexia LdG Banque S.A., Erste Europäische Pfandbrief- und Kommunalkreditbank AG in Luxemburg S.A., Hypothekenbank Frankfurt International S.A., Hypo Pfandbrief Bank International S.A., Nord/LB Covered Finance Bank S.A. and Société Générale Lettres de Gage S.A.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/84/Lettres_de_Gage_publiques, http://ecbc.eu/framework/85/Lettres_de_Gage_hypoth%C3%A9caires and http://ecbc.eu/framework/86/Lettres_de_Gage_mobili%C3%A8res

3.20 THE NETHERLANDS

By Daniëlle Boerendans, ABN AMRO Bank N.V.
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I. FRAMEWORK

The Dutch regulation (the "Regulation") for the issuance of regulated covered bonds ("Regulated Covered Bonds") aims to:

> Provide Dutch issuers with a level playing field with other issuers of covered bonds within the European Union;

> Facilitate a market in safe instruments in accordance with the applicable European directives; and

> Impose solid conditions to protect covered bondholder interests.

The Regulation prescribes a so-called "segregated" structure, being a structure where the cover assets are segregated from the issuer and owned by an independent, special purpose covered bond company (the "CBC"). Under the Regulation, asset segregation takes place on the basis of the Dutch Civil Code and the Dutch Bankruptcy Code. As the applicable statutory provisions are relatively creditor-friendly they did not need to be amended when the Regulation was adopted.

The Regulation is not a separate instrument. It is a collection of rules forming part of two layers of secondary regulation implementing the Dutch Financial Supervision Act (*Wet op het financieel toezicht*, the "FSA"). These are:

> The Decree on Prudential Rules Regulation (*Besluit prudentieel toezicht Wft*); and

> The Implementing Regulation (*Uitvoeringsregeling Wft*).

In January 2011 the Dutch issuers established the Dutch Association of Covered Bond issuers ("DACB"). The DACB's key objectives are to:

> Represent the interests of the Dutch issuers in discussions with legislative and regulatory authorities;

> Provide investors with information about the Dutch covered bond market;

> Participate on behalf of the Dutch issuers in international covered bond organisations like the ECBC; and

> Continuously improve the quality of the Dutch covered bond product offering.

More information on the DACB and its members can be found at www.dacb.nl.

II. STRUCTURE OF THE ISSUER

Under the Regulation the issuer needs to be a bank (i.e. a credit institution as meant in article 4(1a)) of the Banking Consolidation Directive (2006/48/EC; the "BCD") that is licensed by the Dutch Central Bank (*De Nederlandsche Bank N.V.*; "DNB"). General banking supervision by DNB on the solvency, liquidity, business operations et cetera of the issuer falls outside the scope of this chapter.

The Regulated Covered Bonds are guaranteed by the CBC owning the cover assets, thus creating dual recourse for the covered bondholders. The CBC is a special purpose vehicle set up as a bankruptcy-remote, orphan entity, as follows. It is a private company with limited liability (*besloten vennootschap met beperkte aansprakelijkheid*) wholly owned by a foundation (*stichting*), with independent directors provided by a corporate services provider and no employees. It has a limited corporate objects clause, so that any third party dealing with the CBC will be able to see that it is dealing with a special purpose vehicle. Non-petition and limited recourse wording is agreed with all transaction parties that are creditors of the CBC under the transaction documents. Any remaining third party creditors not signing up to such non-petition and limited recourse provisions are listed high in the relevant priority of payments, so as to procure they are timely paid. An insolvency of the issuer does not in itself result in an insolvency of the CBC.

The cover assets are owned by the CBC, but from an accounting perspective the assets remain on the consolidated balance sheet of the issuer, which continues to carry the credit risk of the cover assets. The CBC pledges the cover assets to a security trustee, which is a foundation especially established to act as a security trustee in relation to the relevant Regulated Covered Bonds. The security trustee receives the rights of pledge in its own name, but acts in the interest of the covered bondholders and certain other transaction parties that are creditors of the CBC.

III. COVER ASSETS

The Regulation does not impose the detailed provisions on cover assets as prescribed under Annex VI, Part 1, point 68 of the BCD (together with the Capital Adequacy Directive (2006/49/EC) constituting the Capital Requirements Directive (the "CRD")), but instead only lists the general requirements from section 52(4) of the Undertakings for Collective Investment in Transferable Securities Directive (85/11/EC; "UCITS") as interpreted and implemented by the Dutch Ministry of Finance. The Regulation therefore allows issuers of Dutch Regulated Covered Bonds the flexibility to choose whether their Regulated Covered Bonds are UCITS-compliant only or both UCITS- and CRD-compliant.

For each registered programme, DNB indicates in its Regulated Covered Bond register (as referred to in more detail below) whether the relevant Regulated Covered Bonds are compliant with both UCITS and the CRD.

To date all Dutch Regulated Covered Bond programmes are backed by residential mortgage loans. In addition they allow for inclusion of substitution assets, meaning euro-denominated:

- Cash; or
- Other assets eligible to collateralise covered bonds under the CRD, subject to minimum rating and maximum percentage requirements (this differs per programme).

All programmes allow for inclusion of non-Dutch residential mortgage loans, subject to certain restrictions. In practice all cover pools consist of Dutch residential mortgage loans and, in one programme, German residential mortgage loans.

IV. VALUATION AND LTV CRITERIA

The CRD prescribes that covered bonds may be backed by residential mortgage loans only up to the lesser of (a) the principal amount of the relevant mortgage right and (b) 80% of the value of the underlying mortgaged property. However, relevant Dutch residential mortgage loans may in practice have a loan-to-value ("LTV") ratio of up to 125%. To date, all Dutch Regulated Covered Bond programmes take a two-step approach towards LTV-ratio's of Dutch residential mortgage loans, as follows:

- Subject to some exceptions in some programmes, a loan is only eligible to be transferred to the CBC if the LTV-ratio did not exceed 125% (the "Eligibility Percentage") at origination; and
- Once a loan forms part of the cover assets of the CBC, the maximum value attributed to it in the asset cover test is a certain percentage (the "LTV Cut-Off Percentage") of the value of the underlying mortgaged property at such time. For example, if: (i) the relevant LTV Cut-Off Percentage is 80%; and (ii) a residential mortgage loan has a principal amount of 110 and is backed by mortgaged property with a value of 100, then such loan would be valued at no more than 80 in the asset cover test. The 30 excess value of the loan would serve as extra credit enhancement. Currently the LTV Cut-Off Percentage applied to Dutch residential mortgage loans is:

a) 80% for all Regulated Covered Bonds, which is in line with the maximum LTV ratio prescribed by the CRD; and

b) In some covered bond programmes, notwithstanding the percentages mentioned in the previous two paragraphs, 100% or a different percentage for residential mortgage loans that have the benefit of a Dutch National Mortgage Guarantee (*Nationale Hypotheek Garantie*).

Like the CRD, the Regulation does not prescribe whether the foreclosure value or the market value of the underlying mortgaged property should be taken into account when calculating the LTV ratio. To date under the Dutch Regulated Covered Bond programmes:

> The Eligibility Percentage is applied to the foreclosure value at origination; and

> The LTV Cut-Off Percentage is applied to the market value of the mortgaged property at the relevant time. The way in which the market value is determined differs per programme.

V. ASSET - LIABILITY MANAGEMENT

Under all Dutch Regulated Covered Bond programmes a total return swap in relation to the cover assets is entered into at inception of the programme. The total return swap basically swaps the different types of interest to be received on the cover assets to 1 month's EURIBOR. In addition, an interest rate swap or structured swap is entered into each time a series of Regulated Covered Bonds is issued. The interest rate/structured swap basically swaps the aforementioned 1 month's EURIBOR/euro's to the interest rate/currency payable under the relevant series of Regulated Covered Bonds.

All Dutch Regulated Covered Bond programmes require the issuer to establish a reserve fund equal to, in short, 3 months' interest payments on the Regulated Covered Bonds plus certain costs and expenses for 3 months (or a comparable amount) if the issuer's credit rating falls below F1 (short term) and/or A (long term) (Fitch)/P-1 (short term) (Moody's)/A-1 or A-1+ (this differs per programme)(short term) (S&P).

To mitigate liquidity risk on principal payments all Dutch Regulated Covered Bond programmes use either:

> A pre-maturity test which is taken on each business day falling 6 or 12 months or less prior to the maturity of the relevant Regulated Covered Bonds (depending on the programme and the rating agencies involved). The pre-maturity test is failed if on the relevant test date the issuer's short term rating falls below F1+ (Fitch)/P-1 (Moody's)/A-1+(S&P). A breach of the pre-maturity test requires (a) the issuer to cash-collateralise the relevant maturing Regulated Covered Bonds or (b) the CBC to procure alternative remedies in relation to the relevant maturing Regulated Covered Bonds such as a guarantee of the issuer's obligations, a liquidity facility and/or a sale or refinancing of cover assets; or

> A 12 or 18 months' (this differs per programme) maturity extension. The possible extension applies only to the CBC and only to any final redemption amount payable by the CBC in relation to a series of covered bonds under the guarantee.

For all Dutch Regulated Covered Bond programmes a minimum level of over-collateralisation is required, which is taken into account in a monthly asset cover test where asset percentages are used ranging from approximately 75 to 80%.

VI. TRANSPARENCY

The Dutch issuers of Regulated Covered Bonds use a National Transparency Template, which is based on a template developed for Dutch residential mortgage-backed securities, in order to create more transparency for investors in Regulated Covered Bonds. The Regulated Covered Bond template is in line with the guidelines of the ECBC's Covered Bond Label initiative and can be found on the website of the Covered Bond Label www.coveredbondlabel.com. The reports can be found on the relevant issuer's website. Links to these pages are also available on the website of the DACB: www.dacb.nl.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Under all Dutch Regulated Covered Bond programmes the issuer is obliged to frequently send out investor reports that contain detailed information about, among other things, the cover assets and the performance of a monthly asset cover test. The accuracy of the asset cover test calculation is required to be tested at least annually by an independent auditor. Each year the CBC is required to produce audited financial statements.

When reviewing a Dutch covered bond programme submitted to it for registration under the Regulation, DNB requires:

> A valid safeguarding of sufficient cover assets for the covered bondholders. The assets must be validly transferred by the issuer to the CBC and pledged by the CBC to the security trustee;

> The covered bonds to have a credit rating of at least AA-/Aa3;

> A healthy ratio between the programme/issuance amount on the one hand and, on the other hand, (a) the value of the cover assets, (b) the value of the remaining assets of the issuer eligible for addition to the cover assets and (c) the consolidated balance sheet of the issuer (the latter to protect other stakeholders); and

> The issuer to have solid and effective strategies and procedures for verifying and procuring the sufficiency of the cover assets, taking into account the composition of the cover assets, the over-collateralisation and the applicable risks and stress tests.

The register of Regulated Covered Bond programmes is available on-line and can be found at http://www.toezicht.dnb.nl/en/2/2/51-202602.jsp (click on: Searching in the register).

Once a Dutch covered bond programme is registered by DNB, the issuer will have ongoing administration and reporting obligations towards DNB:

> It must keep a record of all Regulated Covered Bonds issued and of all assets serving as cover assets;

> It must demonstrate at least quarterly that the Regulated Covered Bonds continue to meet the criteria summarised above, by granting DNB access to the records referred to in the previous paragraph and, for instance, audit reports, credit rating reports and reports regarding the cover assets. This is without prejudice to the general authority of DNB to request information from the issuer on the basis of its regular banking supervision powers;

> It must demonstrate at least annually to DNB that it has solid and effective strategies and procedures for verifying and procuring the sufficiency of the cover assets, taking into account the composition of the cover assets, the over-collateralisation and the applicable risks and stress tests;

> Annually, within six months of the close of its financial year, it must submit to DNB the annual financial statements and the annual report of the CBC;

> It must immediately notify DNB if, for as long as any Regulated Covered Bond is outstanding (i) changes occur in respect of the data, transaction documents or other submitted documents, as a result of which the outstanding Regulated Covered Bonds are or will no longer be compliant with the requirements for registration; or (ii) significant changes are made in the covered bond programme or the conditions of the Regulated Covered Bonds; and

> Before it issues any further Regulated Covered Bonds, (i) it must ascertain that the requirements for registration are complied with (there is no need to have the further Regulated Covered Bonds assessed by DNB); and (ii) if the ratio between the total nominal value of the Regulated Covered Bonds and the consolidated balance sheet total of the issuer increases beyond what DNB had determined to be a healthy ratio, the issuer must demonstrate to DNB that the new ratio can be considered healthy.

If the Regulated Covered Bonds no longer meet the requirements set by the Regulation or if the issuer no longer complies with its ongoing administration and reporting obligations towards DNB, there are likely to be short communication lines between the issuer and DNB. If it comes to sanctions, it may be that an issuance-stop is imposed on the issuer, which may be disclosed by DNB in its register. DNB is entitled to ultimately strike the registration of a Regulated Covered Bond programme. In practice it is not very likely that DNB would ever exercise its deregistration authority. Apart from verbal assurance this is confirmed by the explanatory notes to the Regulation, which in short state:

> That deregistration will only occur (a) after due consideration of the interests of the issuer and the covered bondholders and (b) in the exceptional circumstance that DNB's supervision is no longer in the interest of the issuer and no longer grants protection to covered bondholders; and

> That the interests of the issuer and the covered bondholders include that the registration and supervision be maintained.

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

The regulations enabling the segregation of the cover assets and bankruptcy-remoteness of the CBC are set out in the Dutch Civil and Bankruptcy Codes.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

As explained above, Dutch Regulated Covered Bonds are registered either as UCITS-compliant or as UCITS- and CRD-compliant. Dutch covered bonds which are not registered under the Regulation are neither UCITS- nor CRD-compliant.

It differs per type of investor whether investing in a certain category of covered bonds provides regulatory special treatment. For ease of reference such regulatory treatment (for Dutch financial institutions) is set out in more detail below, focusing on Dutch Regulated Covered Bonds:

Dutch Regulated Covered Bond category		UCITS -compliant	UCITS- and CRD-compliant
Type of investor			
UCITS and insurers		Higher investment limits	Higher investment limits
Banks and invest-ment firms using:	Standardised Approach	None	- Lower risk weighting
	Foundation Internal Ratings Based (IRB) Approach	None	- Lower loss given default value

A further regulatory special treatment which is not reflected in the above diagram, is available to CRD-compliant Dutch Regulated Covered Bonds in the context of banks and investment firms entering into repurchase transactions (repo's) with the Dutch issuer. If the issuing Dutch bank posts its own CRD-compliant Regulated Covered Bonds as collateral under the repo, then such covered bonds qualify as financial collateral under Annex VIII, part 2, point 6 of the BCD for the purpose of mitigating the credit risk of the bank/investment firm on the issuing Dutch bank as its repo counterparty if such Regulated Covered Bonds are CRD-compliant.

Finally, if Dutch Regulated Covered Bonds are UCITS-compliant, they receive special treatment from the European Central Bank ("ECB") in determining their eligibility for monetary policy operations (such as the marginal lending facility to obtain overnight liquidity from national central banks), including:

> They do not need to be admitted to trading on a regulated market (as defined in the Markets in Financial Instruments Directive; MiFID); and

> Unlike other asset-backed securities:

a) They are not eligible for an exemption from the general rule that debt instruments must have a fixed, unconditional principal amount;

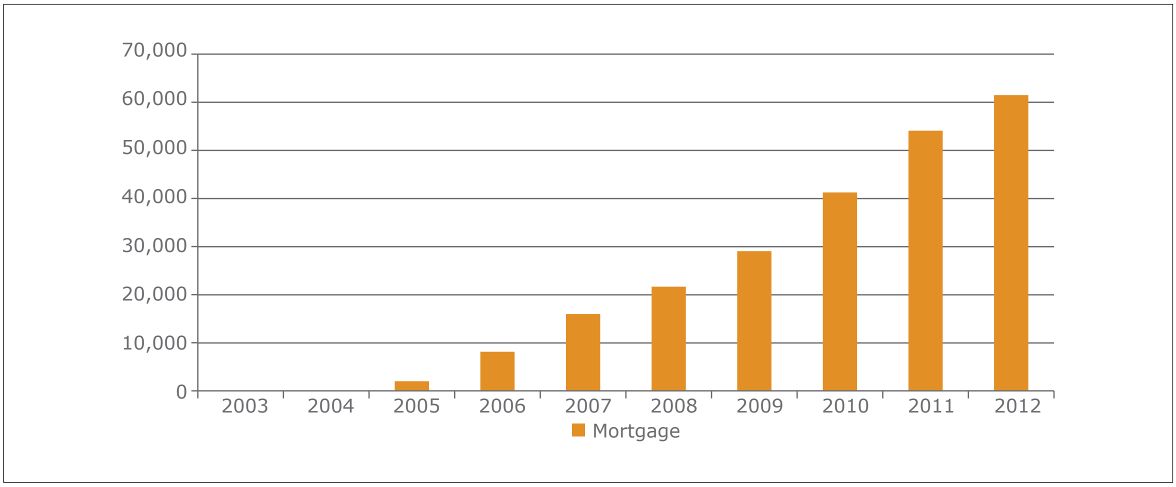
b) They may be backed by credit-linked notes or similar claims resulting from the transfer of credit risk by means of credit derivatives; and

c) They are exempt from certain true sale requirements. In addition, if issued prior to 1 January 2008, they are exempt from certain credit quality thresholds. However, these exemptions are of lesser relevance for Dutch UCITS-compliant covered bonds because the Regulation requires a segregated structure as well as a credit rating of at least AA-/Aa3.

X. ADDITIONAL INFORMATION

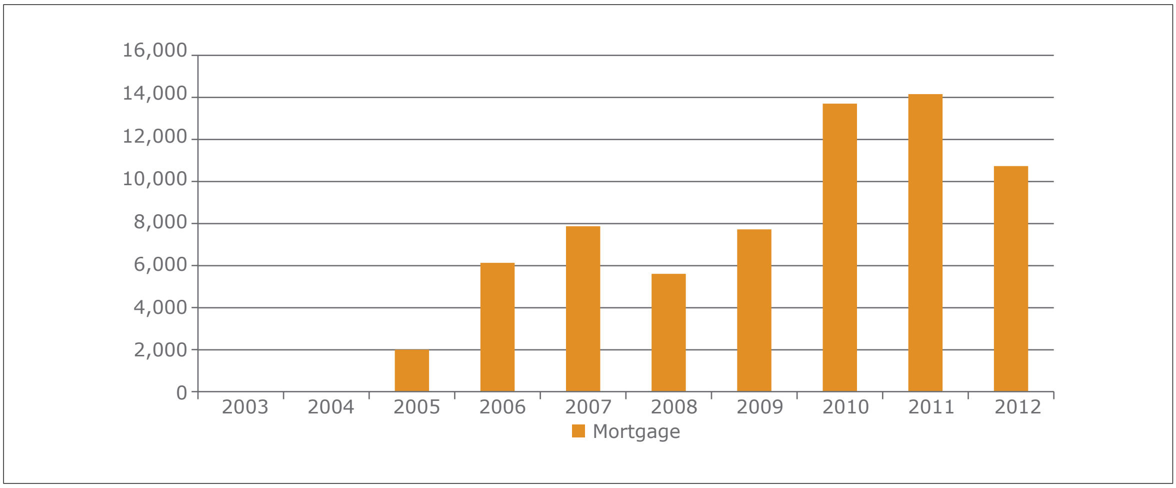
On 7 January 2011 the Dutch Association of Covered Bond Issuers (the "DACB") was established. The statutory aim of the DACB is generally to promote the interests, both national and international, of Dutch covered bond issuers and aims for a strong, healthy and internationally competitive covered bond market in the Netherlands. The website of the DACB can be found at: www.dacb.nl.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2012, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2012, EUR M



Source: EMF/ECBC

Issuers: Currently there are four issuers of Regulated Covered Bonds in the Netherlands: ABN AMRO Bank N.V., ING Bank N.V., NIBC Bank N.V.and SNS Bank N.V.. Achmea Hypotheekbank N.V.'s covered bond programme is in the process of being approved by DNB.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/65/Dutch_registered_CBs_programmes

3.21 NEW ZEALAND

By Frank Will, RBS and Geoff Martin, Kiwibank

SUMMARY

The first covered bond was issued out of New Zealand in June 2010. At that time, New Zealand did not have a legislative covered bond framework and the domestic issuers used the well-tested general law-based covered bond approach following in the footsteps of the UK, France, and Canada. Since then, the regulatory authorities in New Zealand have developed a dedicated covered bond legislation to support further growth of this market segment. In May 2012, the Minister of Finance introduced the Reserve Bank of New Zealand (Covered Bonds) Amendment Bill into Parliament. In February 2013, the second reading took place. As of July 2013, the Amendment Bill remains before the New Zealand Parliament, awaiting presentation to the Committee of the House and the third and final reading. After passing its third reading, it will receive Royal Assent and become formally legislated. Once the legislation comes into force, banks will only be able to issue covered bonds under registered programmes. This means that programmes that existed before the legislation came into force will have to be registered before the banks can issue new bonds under those programmes. However, there will be a transition period to enable the registration of existing covered bond programmes. Once programmes are registered, issues under the programme prior to registration will also receive the benefit of the legislation.

I. FRAMEWORK

No covered bond regulation was in place in June 2010 when New Zealand covered bonds were first issued and issuance of covered bonds was neither prohibited nor limited by any prudential requirements or other regulation.

In October 2010, the central bank released a consultation paper on proposals for a regulatory framework to provide additional certainty to investors, and to improve the disclosure requirements in order to support the development of the covered bond market in New Zealand.

In January 2011, the Reserve Bank of New Zealand (RBNZ) introduced a regulatory issuance limit for the issuance of covered bonds by New Zealand banks (which came into force in April 2011). The regulation limits the value of assets encumbered for the benefit of covered bondholders to 10% of total assets of the issuing bank. At that time the RBNZ said that this was an initial limit and that its appropriateness would be reviewed by the central bank within the next two years (i.e. by 2013), taking into account the developments within the covered bond market in New Zealand.

In December 2011, the RBNZ conducted another public consultation. The final paper was in essence aligned with the earlier consultation paper. Following approval by Cabinet in April 2012, the Reserve Bank released a Cabinet paper and Regulatory Impact Statement confirming policy positions relating to the matters discussed in the Reserve Bank's December 2011 consultation paper on covered bonds.

In May 2012, the first reading on the Amendment Bill took place. Following its first reading, the Bill was referred to the Finance and Expenditure Select Committee. In February 2013 the second reading took place. As of July 2013, the Amendment Bill remains before the New Zealand Parliament, awaiting a third and final reading. Once it passes its third reading, it will receive Royal Assent and become formally legislated.

The proposed New Zealand covered bond legislation will allow existing covered bond issuers nine months to register their covered bond programme with the RBNZ. Each issuance under the programme is also proposed to be registered with RBNZ. Once a programme is registered existing issues under the programme will receive the benefit of legislation. In addition several existing covered bond issuers in New Zealand have a clause in their prospectus allowing them to exchange, without the consent of the trustees or the covered bond holders, any existing covered bond for a new covered bond, provided that amongst other things, each of the rating agencies then rating the existing covered bonds confirms in writing that any such new covered bonds will be assigned the same ratings as the existing covered bonds. The new bonds would be subject to the same economic terms and conditions as the existing bonds and would be identical in form, amounts and denominations.

II. STRUCTURE OF THE ISSUER

As of the beginning of July 2013, issuers from five New Zealand banking groups have issued covered bonds, being ANZ Bank New Zealand Limited (ANZ), ASB Bank Limited (ASB), BNZ and Westpac New Zealand Limited (Westpac) and Kiwibank (New Zealand Post Limited). However, in the first four cases, the ultimate Australian parent companies ANZ, CBA, NAB and Westpac do not guarantee the covered bonds. Typically, NZD denominated bonds have been issued directly by the New Zealand banks, while non-NZD bonds have been issued through the London branches of their respective subsidiaries and are guaranteed by the New Zealand parent company. The RBNZ emphasised from the outset that it is supportive of the covered bond product.

Banks can issue bonds backed by a dynamic pool of assets, and the covered bonds rank pari-passu to each other. The covered bonds are irrevocably guaranteed by the covered bond guarantor (CB guarantor) under the covered bond guarantee. The CB guarantor will only make payments under the bonds when (a) an issuer event of default has occurred, and a notice to pay is served on the CB guarantor or, (b) a CB guarantor event of default has occurred and a covered bond guarantee acceleration notice is served on the CB guarantor and the issuers.

III. COVER ASSETS

The existing covered bond programmes are backed by a dynamic pool of residential mortgage loans originated in New Zealand.

The common eligibility criteria for these mortgage loans across the programmes are listed below:

- Denominated and repayable only in New Zealand Dollars (NZD);
- Secured by first ranking residential mortgages in New Zealand;
- Mortgage loans with a term not exceeding 30 years;
- Outstanding principal balance of no more than NZD 1.5 m (Westpac)/NZD 2.0 m (ANZ, ASB, Kiwibank)/ NZD 2.5 m (BNZ); and,
- Not in arrears/have not been in default for more than 30 days

Some of the issuers have additional features beyond these requirements. Moreover, issuers are also allowed to hold liquid substitution assets. These assets, are subject to an overall limit of 10-20% of the cover portfolio depending on the issuer (Westpac 20%, BNZ 15%, ANZ, ASB and Kiwibank 10%), with the exception of cash that has no limit.

Although the covered bond legislation is yet to be finalised, the current proposal foresees a "registration framework", under which investors' rights to the asset pool of a registered covered bond would be protected from the issuer insolvency (or statutory management of the issuer) rather than a "safe harbour framework", under which the investors' rights to the asset pool of a covered bond would be protected if the covered bond programme fulfils the requirements of the covered bond law.

The mandatory registration would involve the recognition of a covered bond issued with the effect that the cover assets would be explicitly protected from the insolvency or statutory management of the issuer. The RBNZ must keep a public register of registered covered bond programmes and issuances under each programme. The draft law requires the Reserve Bank to determine the form and content of the register and can designate registered covered bond programmes to particular classes of programmes depending on the underlying assets.

The proposed law requires that the cover pool assets are held by a Special Purpose Vehicle (SPV), which is a separate legal entity from the issuer.

IV. VALUATION AND LTV CRITERIA

In New Zealand, every property is typically valued during the underwriting process. All five existing covered bond programmes do not restrict the LTV limit for mortgage loans in the cover pool. However, in the case of ASB and Westpac, the Assets Coverage Test (ACT) caps the valuation of the property at 75%. In case of ANZ, BNZ and Kiwibank this cap is set at 80%. In effect, this means the maximum amount of a loan that can count in the ACT test is 75% or 80% of the property value respectively.

V. ASSET-LIABILITY MANAGEMENT

Issuance limit: As mentioned above, there is a regulatory issuance threshold which limits the value of assets encumbered for the benefit of covered bond holders to 10% of the total assets of the issuing bank. RBNZ highlights that this is an initial limit and its appropriateness will be reviewed taking into consideration the development of the covered bond market. The RBNZ states that the 10% limit is "similar to the limit set in Australia" of 8%. However, the limit is "specified differently" from Australia's. "The New Zealand limit applies at all times, whereas the Australian limit applies only at the time of issuance. In addition, if an Australian bank holds cover pool assets in excess of the limit, it must deduct the value of the excess amount from its capital in calculating its regulatory capital adequacy ratios: if a New Zealand bank breaches its cover pool limit, it is in breach of its conditions of registration."

Currency & interest hedging: The underlying mortgage loans are denominated in NZD. However, covered bonds can be issued in other currency denominations, which introduces currency risk for the issuer. Moreover, the interest payable for the covered bonds will not exactly match the interest received on the mortgage loans in the collateral pool. Under the existing covered bond programmes, the issuers are required to hedge the interest and currency risks.

Soft vs hard bullet structures: The existing issuers (ANZ, ASB, BNZ, Kiwibank and Westpac) can issue hard bullet covered bonds, or covered bonds with extendable maturity of one year ("soft bullet" bonds). Hard bullet covered bonds will, depending on short term rating of the relevant bank, be subject to a 12-month pre-maturity test giving the CB guarantor 12 months to raise liquidity by selling assets of the pool.

Over-collateralisation (OC): The issuers have committed to various OC levels under the prospectuses and to the rating agencies. The proposed law only requires that the value of the cover pool assets is at least equal to the principal amount outstanding on the covered bonds.

VI. COVER POOL MONITOR AND BANKING SUPERVISON

The existing issuers provide investor reports on a monthly or quarterly basis. In addition, monthly or quarterly reports are prepared for the rating agencies. The agencies re-calculate the required asset percentage used in the ACT on a regular basis and prior to each issuance under the respective covered bond programme.

An independent asset monitor annually checks the arithmetic accuracy of the calculations performed by the calculation manager (usually the issuer), with respect of the asset coverage test or amortisation test (as applicable). If the issuer rating of the calculation manager is downgraded below a certain trigger level, the asset monitor will check the arithmetic accuracy on a monthly basis. Moreover, (1) if the asset monitor notices any errors in the calculations performed by the calculation manager which result in a failure in the asset coverage test or (2) if the adjusted aggregate mortgage loan amount or the amortisation test aggregate mortgage loan amount is misstated by the calculation manager by an amount exceeding 1%, then the asset monitor will be required to test the calculation monthly for a period of six months.

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

The covered bonds are direct, unsecured, unsubordinated and unconditional obligations of the relevant issuer. In addition, the CB guarantor guarantees the payments of interest and principal of the covered bonds. The issuer provides a subordinated loan to CB guarantor which allows the CB guarantor to acquire a mortgage loan portfolio. The portfolio includes mortgage loans and the related security sold by the seller in accordance with the terms of the mortgage sale agreement.

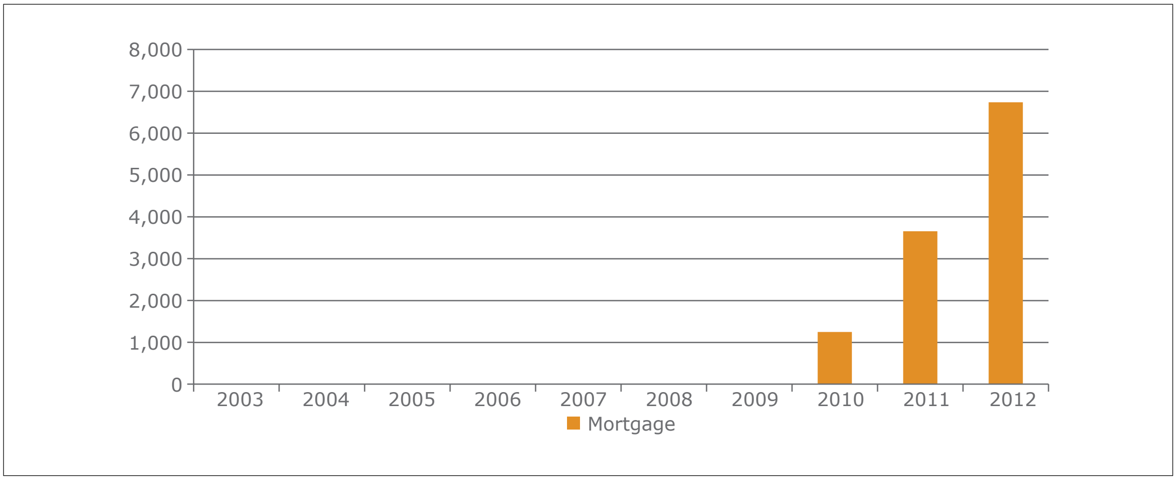
Under the existing covered bond programmes, the sale of the loans and their underlying security by the seller to the CB Guarantor is in form of equitable assignment of the seller's rights, title, interest and benefit in and to the loans, their related security and the other assets which are being sold. The equitable assignment requires neither a notice to the borrowers nor a registration in the land registry. As a result, the legal title to the mortgage loans remains with the seller until legal assignment is delivered to the CB guarantor and notice of perfection of legal title is given to the borrowers. The perfection of title of the mortgage security to the CB guarantor will be triggered by certain trigger events including the notice to pay on the CB guarantor, downgrade of the issuer to sub-investment grade or insolvency of the issuer. The equitable assignment is a well-known procedure in the UK and is usually used by the covered bond issuers in the UK.

VIII. RISK WEIGHTING AND COMPLIANCE WITH EUROPEAN LEGISLATION

The Reserve Bank of New Zealand accepts NZD denominated AAA rated covered bonds for its Domestic Markets Operations. For maturities of less than three years the haircut is 5% while covered bonds with a maturity of three years or longer are subject to a higher haircut of 8%. This includes covered bonds issued by New Zealand banks.

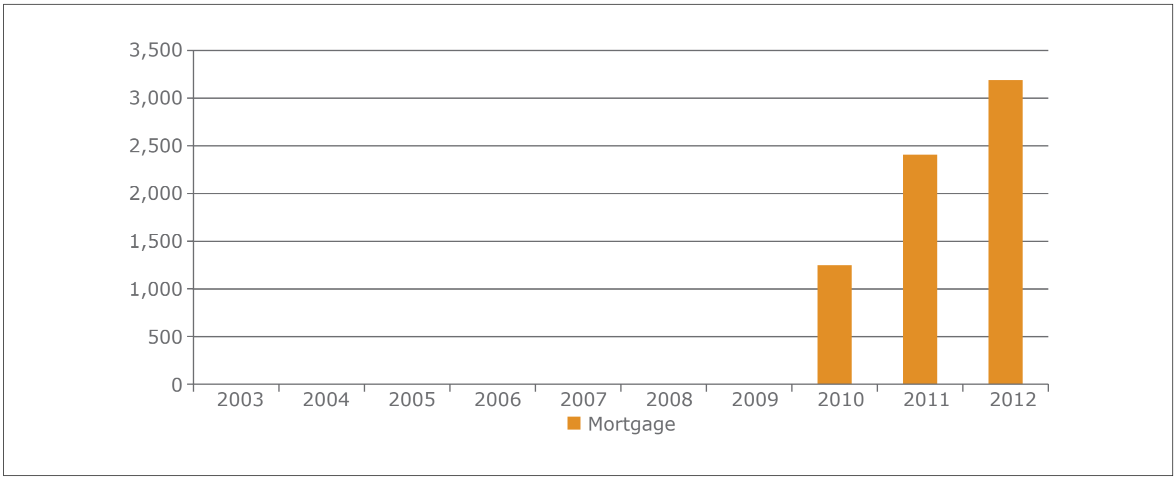
The covered bonds issued directly by financial institutions with registered offices in New Zealand are neither CRR nor UCITS compliant as both frameworks require the issuer to be based in the EU. Moreover, the UCITS Directive (and therefore the CRR) requires special legal supervision – usually in form of a dedicated covered bond law which as of July 2013 does not yet exist in New Zealand. The New Zealand covered bonds, therefore, do not benefit from the lower risk weighting for bank treasuries in the EU.

> Figure 1: Covered Bonds Outstanding, 2003-2012, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2012, EUR m



Source: EMF/ECBC

3.22 NORWAY

By Stein Sjølie and Torkil Wiberg, Finance Norway

I. FRAMEWORK

In June 2013 the Norwegian covered bond legislation passed its sixth year milestone. The legislation was a result of a lengthy study and is closely matching corresponding EU directives and regulations, in particular the CRD, which was adopted and implemented in Norway in late 2006. The legislative framework has so far proved to be a solid and sustainable base for the issuers' commercial activity. The law provides investors strong protection from the issuing institution's cover pool, and the Norwegian covered bonds are seen as being among the best in class of European covered bonds. The high quality of Norwegian covered bonds is supported by the Kingdom of Norway's very strong macroeconomic position.

Three specialised institutions were established from the beginning and started issuance of Norwegian covered bonds in international markets during the second half 2007. This activity had thus barely started when the crisis hit the international financial markets the following year. In order to provide liquidity to the Norwegian banking market the authorities opted to swap treasury bills against covered bonds with Norwegian banks and mortgages institutions. This gave an impetus to the fledgling domestic market of covered bonds; a large number of banks established new subsidiaries in order to take advantage of this liquidity window. Today there are 22 Norwegian specialized credit institutions licensed to issue covered bonds. The smallest ones only operate in the domestic market. The largest issuers already have been, and are expected to continue to be, present in the international capital markets on a regular basis.

II. STRUCTURE OF THE ISSUER

The Norwegian Covered Bond legislation entered into force on 1 June 2007. Relevant amendments were made to the Financial Services Act, hereafter "the Act", and, at the same time, the Ministry of Finance adopted a supplementary regulation, hereafter "the Regulation", to the Act. The legislation permits specialized mortgage credit institution to raise loans by issuing covered bonds. These institutions are licensed credit institutions, supervised by the Financial Supervisory Authority of Norway – Finanstilsynet, hereafter the FSA. They are subject to the same type of regulations as other Norwegian financial institutions, for example capital adequacy requirements, general requirements for liquidity management etc.

A commercial bank or a savings bank will not be allowed to issue such bonds in its own name, but may establish a mortgage credit institution as a subsidiary. Alternatively, a mortgage credit institution may be established as an independent institution with several shareholders.

A licensed mortgage credit institution may raise loans by issuing covered bonds where the object of the institution, as laid down in the articles of association, is (1) to grant or acquire specified types of mortgages and public sector loans and (2) to finance its lending business primarily by issuing covered bonds. The articles of association of the institution shall state which types of loans that shall be granted or acquired by the institution. The scope of the business will therefore be restricted and the institution will have a very narrow mandate. Thus, Norwegian issuers of covered bonds are transparent companies.

III. COVER ASSETS

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

> Residential mortgages

> Commercial mortgages

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

> Public sector loans

> Assets in form of derivative agreements (in accordance with the Regulation)

> Substitute assets (in accordance with the Regulation)

The mortgage loans have to be collateralized with real estate or other eligible assets within the EEA or OECD, and the public sector loan borrowers have to be located within the EEA or OECD. The Regulation adds rating requirements on the individual public sector borrowers, if located outside the EEA.

The derivate agreements and the substitute assets are, logically, accessory to the loans. The substitute assets may only amount to 20% of the cover pool (30% for a limited period of time with the consent of the FSA). In addition, the substitute assets ought to be secure and liquid. The Regulation adds requirements necessary in order to comply with the description of covered bonds given in EU Directive 2006/48/EC. Counterparty and rating regulations in accordance with the directive apply to these two asset classes, as well as to the public sector loans.

IV. VALUATION AND LTV CRITERIA

Loan to value ratios (LTV) and monitoring are fixed by the Regulation, in accordance with the EU Directive 2006/48/EC. For residential mortgages the LTV is 75%. For holiday houses and commercial mortgages the LTV-limit is 60%. The mortgage credit institution shall monitor the development of the LTV of the individual asset as well as the market of the underlying assets, according to the Act, and in accordance with the said directive.

Upon inclusion of loans in the cover pool, a prudent market value shall be set. The market value for a property shall be set individually by an independent and competent person. The valuation shall be documented. However, valuation of residential properties may be based on general price levels.

Predominantly, residential properties in Norway are sold in open auctions in the market. Hence the actual selling price in principle reflects the market value and a recent sales contract may serve as documentation of the market value of a property.

The mortgage institution shall establish systems for monitoring subsequent price developments. Should property prices later fall, that part of a mortgage that exceeds the relevant LTV limit is still part of the cover pool and protects the holders of preferential claims. However, that part of a loan that exceeds the LTV limit is not taken into account when calculating the value of the cover pool to compare it with outstanding covered bonds, please refer to the matching regulations as described below. The same principle applies to loans that are in default, i.e. more than 90 days in arrears.

V. ASSET - LIABILITY MANAGEMENT

The Act establishes a strict balance principle, i.e. the value of the cover pool shall at all times exceed the value of the covered bonds with a preferential claim over the pool. The Regulation establishes a strict mark to market principle of both assets and liabilities. Only the value of mortgages within the LTV limits is taken into account in this context. Also, the act caps the maximum exposure to one single borrower at 5% of the cover pool when compliance with the matching requirement is assessed.

There is no requirement in the legislation for a certain percentage of overcollateralization (OC). However, if an issuer chooses to provide voluntary OC, these assets are part of the cover pool, and bankruptcy remote in case of the issuer going into bankruptcy proceedings. The issuing institutions typically declare a certain level of OC, e.g. 5%, to which they are bound. Equally, the mortgage credit institution shall ensure that the payment flows from the cover pool enable the institution to honour its payment obligations.

The mortgage institution may enter into derivative agreements in order to secure the balance principle and payment obligations. If it has a positive market value, a derivative agreement will be part of the cover pool; if negative, the counterparties to derivative agreements will have a preferential claim over the pool, pari passu with the holders of covered bonds. As a corollary to this, the counterparties in the derivative agreements will be subject to same restrictions with respect to declaration of default as the bondholders. In addition to this, the mortgage institution will have to adopt strict internal regulations with respect to liquidity risk, interest rate risk and currency risk.

VI. TRANSPARENCY

Growing investor activism has initiated a work aimed at increasing transparency in the issuing institutions and in particular in the cover pool. At the initiative of an international investor organization, the Covered Bond Investor Council – CBIC, The Norwegian Covered Bond Council undertook a work to establish a Norwegian template, in accordance with the one from CBIC. The Norwegian template was published on The Norwegian Covered Bond Council's web page early 2012, see Finance Norway's website: http://www.fno.no/en/main/covered-bonds/cbic-european-transparency-standards/, or the Covered Bond Label website: https://www.coveredbondlabel.com/issuers/national-information-detail/17/. So far (May 2013), there are three Norwegian issuers Labelled (DNB Boligkreditt, Nordea Eiendomskreditt and SpareBank 1 Boligkreditt), with several more issuers expected to apply for the Covered Bond Label.

The template sets transparency standards for the cover pool data that individual issuers want to publish. The issuers have started to report cover pool information in accordance with the template. Links to the different issuers' individual websites, containing the cover pool information, are available on The Norwegian Covered Bond Council's web page: http://www.fno.no/en/main/covered-bonds/. However, to further enhance the transparency of the issuers it is important that the template is used "as is", either alone or in addition to the individual issuers prevailing template. The Norwegian Covered Bond Council has therefore decided to undertake a revision of the template to improve the layout and suitability.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Mortgage and other credit institutions are regulated under chapter 3 of the Act. This chapter sets out the general provisions for a credit institution, i.e. the obligation to obtain a license and to fulfill capital requirements and undertake organizational measures etc.

The issuing of covered bonds is regulated by chapter 2, subchapter IV of the Act. The issuance of such bonds is not subject to any further governmental approvals. However the articles of association shall be approved by the FSA. Furthermore, the institution shall notify the FSA no later than 30 days prior to the initial issuance of covered bonds. The FSA has the power to instruct licensed mortgage institutions not to issue covered bonds whenever the financial strength of the institution gives rise to concern.

The mortgage institution shall maintain a register of issued covered bonds and of the cover assets assigned thereto, including derivative agreements. To oversee that the register is correctly maintained an independent inspector shall be appointed by the FSA. The inspector shall also regularly review compliance with the requirements concerning the balance principle, and report to the FSA, yearly or whenever the institution does not comply.

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

The Act gives the bondholders a preferential claim over the cover pool in case of bankruptcy. The term "covered bonds", or literally "bonds with preferential claim" (in Norwegian "obligasjoner med fortrinnsrett") is protected by law. In case of bankruptcy of the mortgage credit institution an administrator shall be appointed by the court. The assets in the pool remain with the estate in case of bankruptcy, but the bondholders have exclusive, equal and proportionate preferential claim over the cover pool, and the administrator is bound to assure timely payment, provided the pool gives full cover to the said claims.

The preferential claim also applies to payments that accrue to the institution from the cover pool. And, as long as they receive timely payments, the creditors have no right to declare default. Details about this may be reflected in the individual agreements between the issuer and (the trustee of) the bondholders. These provisions will also apply to any netting agreements between the institution and its counterparties in derivative transactions.

Bankruptcy or insolvency does not in itself give holders of covered bonds and derivative counterparties right to accelerate their claims. However, should it not be possible to make contractual payments when claims fall due, and an imminent change that will ensure such contractual payments is unlikely, the bankruptcy manager shall introduce a halt to payments. Thereafter further administration of the cover pool shall proceed under the general bankruptcy legislation.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation fulfils and is in compliance with the relevant EU legislation, i.e. EU Directive 2006/48/EC and in particular UCITS Directive, Article 52 (4). Hence, the Norwegian Covered Bonds being in compliance with the UCITS and the CRD, are eligible for reduced (10%) risk weighting under the standard method for capital adequacy requirement. The Norwegian Covered Bonds are also eligible as collateral in ECB.

The issuers are licensed credit institutions under supervision of the Norwegian FSA, and as such bound to comply with all relevant single market directives and regulations applicable to European credit institutions.

X. ADDITIONAL INFORMATION

Legislation supplementing the covered bond legislation

The legal framework regulating the housing market is well developed. This framework provides legal certainty and foreseeability for both consumers as borrowers and owners of housing, and for credit institutions as lenders and creditors. This includes specific consumer protection legislation, a centralized electronic registry system for the ownership of and rights (mortgage, etc.) in real estate, and an effectively and expedient forced sale procedure.

The Financial Contracts Act (Act 1999-06-25 no. 46) regulates the contractual conditions in respect of a loan agreement between financial institutions and their customers, both consumers and corporate clients. The Act applies in principle to all types of loans, whether they are secured or not. This also includes mortgage backed loans included in a cover pool. The act is invariable in respect of consumer contracts, i.e. it cannot be dispensed with by agreement that is detrimental to the customer.

The Mortgage Act (Act of 8 February 1980 no. 2) regulates i.a. mortgages on real estate. Mortgage rights acquire legal protection by registration in the Land Registry/Register of Deeds.

The Forced Sales Act (Act of 26 June 1992 no.86) provides for an effectively and expedient forced sale procedure. A lender may, if a loan is accelerated and the borrower fails to pay any due amount, file an application before the county court for a forced sale of the property that backs the mortgage loan. The registered mortgage contract will itself constitute basis for such application. The court will normally appoint a real estate broker to administer the sale in order to obtain a reasonable price. Normally, nine to twelve months are required to repossess the property and satisfy the holder of a mortgage.

Market overview

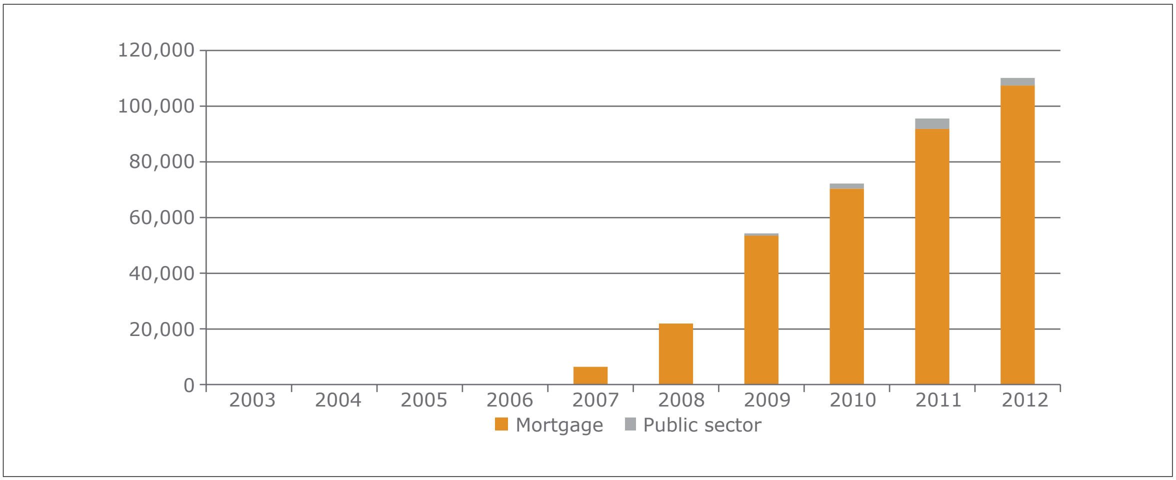
The covered bonds are listed. Virtually all active issuers have issues listed on the Norwegian market places offered by Oslo Børs, either on the regulated market or on Oslo ABM, the non-regulated market place run by Oslo Børs. International issues may be listed in a financial centre abroad.

The Norwegian Government's swap program that was introduced to provide extra liquidity to the market at the outbreak of the financial crisis was discontinued by end 2009. Since then, there has been no government sponsored program stimulating the market for covered bonds. Of the total amount of NOK 230 bn. (ca. EUR 30 bn.) of Norwegian covered bonds that were lodged in the swap agreements during 2008 and 2009, NOK 120 bn. (ca. EUR 15,7 bn.) still remain in the Treasury (April 2013). As these swap agreements come to maturity during

2013 and 2014, the bonds have to be refinanced in the market. The amount corresponds to less than one year's current issuance in the market. The transaction activity and the liquidity in the Norwegian market have showed an increasing trend since the improvement of the capital market after the financial crisis.

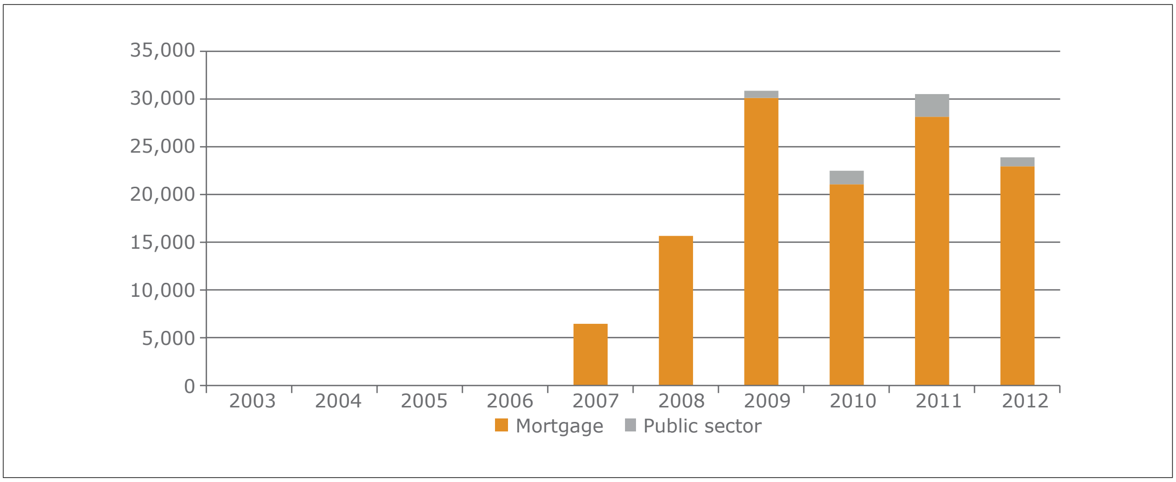
Norwegian covered bond issuers issued a total of almost EUR 24 bn. during 2012. Of this amount approximately 40 % was issued in the domestic (NOK) market. Just over EUR 12 bn. was placed in the euro market, while other currency issuance (mainly USD) accounted for around EUR 2 bn. Although the primary market activity fell slightly through the second half of 2012, the total outstanding amount passed the EUR 100 bn. mark by the end of the year. By April 2013 there are a total of 195 issues traded on the Norwegian market places, with a volume exceeding that of Norwegian Government bonds.

> Figure 1: Covered Bonds Outstanding, 2003-2012, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2012, EUR m



Source: EMF/ECBC

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/75/Norwegian_Covered_Bonds

3.23 PANAMA

By Frank Will, RBS

I. FRAMEWORK

In September 2012, Global Bank became the first issuer of covered bonds out of Panama. It was also Latin America's inaugural covered bond. The USD 200 m deal was issued under Global Bank's USD 500 m Residential Mortgage Loans Covered Bond Programme. As of July 2013, we have not seen any new issuance or new covered bond issuers out of Panama since then.

Panama currently does not have a specific legal framework for covered bonds. Thus, Panamanian covered bonds are based on contractual agreements and the programme characteristics are self-imposed. Similar to the structures used in other markets without a specific covered bond law, many programme features are derived from securitisation techniques. Please note that our country analysis is based on the only available covered bond programme in Panama to date, the one from Global Bank.

II. STRUCTURE OF THE ISSUER

In the absence of a specific covered bond law in Panama, Global Bank Corp. y Subsidiarias used certain securitisation techniques and contractual law to replicate the key features of specific law based covered bonds and to ensure that the cover pool is isolated in the event of issuer insolvency. The covered bonds represent direct unconditional and unsubordinated obligations of the issuer and rank pari passu among themselves. The covered bond programme has a separate cover pool of Panamanian residential mortgage assets that is transferred to a guaranty trust. The covered bond holders have a priority claim on these assets.

III. COVER ASSETS

Given the lack of other Panamanian covered bond issuers, we focus below on the asset requirements of Global Bank's covered bond programme. Under Global Bank's covered bond programme, the covered bonds are backed by a dynamic pool of first-ranking residential mortgage loans originated in Panama.

The residential mortgage loans are subject to various eligibility criteria:

- The loans must be denominated in USD;
- The mortgage borrowers must be individuals resident in Panama;
- Each loan is secured by a valid and enforceable mortgage or by a guaranty trust, in accordance with Panamanian Law over a fully completed residential property located in Panama;
- With respect to any loan, there are no other loans secured by mortgages or by a guaranty trust ranking pari passu or senior with the mortgage or guaranty trust securing such loan (if there are other loans secured by mortgages or by a guaranty trust and ranking pari passu or senior with the mortgage or guaranty trust securing such loan, such loans have also been originated by the issuer and are included in the portfolio);
- No loan has a current principal balance of more than USD 500,000;
- Each loan has a remaining term of no longer than 30 years; and,
- No loan that has been transferred to the guarantee trust has been more than 90 days in arrears during the calendar year preceding the transfer date.

The aggregate principal amount of substitution assets (and/or authorised investments) may not at any time exceed 20% of the aggregate principal balance of the Guaranty Trust Assets.

IV. VALUATION AND LTV CRITERIA

The maximum permitted LTV is 100% in Global Bank's covered bond programme. For non-preferential first lien mortgages the LTV caps are lower (95% for salaried borrowers, 85% for self employed and 70% for foreign borrowers). The Asset Coverage Test does not give any credit to mortgage loans more than 90 days past due. The maximum asset percentage is set at 84.4%.

V. ASSET - LIABILITY MANAGEMENT

Global Bank's covered bond features several tests including an Asset Coverage Test, an Interest Shortfall Test, a Yield Shortfall Test and an Amortisation Test.

> **Asset Coverage Test:** The Asset Coverage Test is breached if, on any calculation date prior to the occurrence of an Issuer Event of Default and the service of a Notice to Pay on the Guaranty Trustee, the Adjusted Aggregate Loan Amount is less than the aggregate Principal Amount Outstanding of the covered bonds.

> **Interest Shortfall Test:** The Interest Shortfall Test is breached when, on any calculation date prior to the occurrence of an Issuer Event of Default and service of a Notice to Pay on the Guaranty Trustee, the income received with respect to the Guaranty Trust Assets (including interest received or amounts received on hedging instruments) during the calculation period plus other available amounts (representing interest) is less than the interest amounts expected to accrue under the covered bonds during the next succeeding Guaranty Trust Payment Period.

> **Yield Shortfall Test:** The Yield Shortfall Test is breached when, on any calculation date following an Issuer Event of Default and service of a Notice to Pay on the Guaranty Trustee, interest amounts under the loans and other amounts (representing interest) received by the Guaranty Trustee in respect of the Guaranty Trust Assets during the calculation period cease to give a yield on the Loans at least equal to the weighted average interest rate on the outstanding Series of covered bonds.

> **Amortisation Test:** The Amortisation Test is breached if, for so long as any Covered Bonds remain outstanding upon the occurrence of an Issuer Event of Default and on any calculation date following the occurrence of an Issuer Event of Default and the service of a Notice to Pay on the Guaranty Trustee (but prior to the service of a Guaranty Trust Acceleration Notice), the Amortisation Test Aggregate Loan Amount is less than the aggregate Principal Amount Outstanding of the covered bonds as at the Determination Date

The issuer can issue covered bonds in hard bullet or soft bullet format. In case of soft-bullet bonds, the outstanding covered bonds' maturity will automatically be extended by up to 12 months if the issuer fails to fully redeem a series.

VI. TRANSPARENCY

Global Bank's prospectus requires the bank to prepare a monthly investor report listing selected statistical information in relation to the underlying portfolio and the characteristics of the portfolio as well as confirming compliance with the Asset Coverage Test. The issuer provides comprehensive information on the borrowers (income brackets, employment type, life insurance), delinquency rates, fire & earthquake insurance of the properties, loan-to-value ratios by brackets and charged interest rates.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The Asset Monitor reports on the arithmetic accuracy of the calculations performed by the Cash Manager on the Calculation Date immediately prior to the Guaranty Trust Payment Date at the end of each fiscal quarter with a view to confirmation of compliance with the Asset Coverage Test or the Amortisation Test on that Calculation Date. Following the occurrence of a Servicer Termination Event, the Asset Monitor will, subject to receipt of the relevant information from the Cash Manager, be required to report on such arithmetic accuracy following each Calculation Date and, following a determination by the Asset Monitor of any errors in the calculations performed by the Cash Manager such that the Asset Coverage Test has been failed on the applicable Calculation Date or the Adjusted Aggregate Loan Amount or the Amortisation Test Aggregate Loan Amount is mis-stated by an amount exceeding one per cent of the Adjusted Aggregate Loan Amount or the Amortisation Test Aggregate Loan Amount, the Asset Monitor will be required to verify the procedures and calculations made by the Cash Manager on each Calculation Date for a period of six months thereafter.

The Cash Manager will check compliance with the Tests on each Calculation Date. The Asset Monitor will periodically check compliance. If any of the Tests noted above are not satisfied and the breach is continuing, the Issuer must take prompt remedial action. The Issuer will immediately notify the Trustee of the breach of any of the Tests. In the event of a breach of either the Asset Coverage Test or the Interest Shortfall Test which is continuing, the Issuer will not be permitted to issue.

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

As mentioned above, the covered bonds will be direct and unconditional obligations of the issuer but are secured by the Guaranty Trust Assets. The Guaranty Trustee has no obligation to pay the amounts set out in the Guaranty Trust Priority of Payments until the occurrence of an Issuer Event of Default, service by the Trustee on the Issuer of an Issuer Acceleration Notice and on the Guaranty Trustee of a Notice to Pay. There are a number of features of the Programme which are intended to enhance the likelihood of timely payments to covered bond holders: (1) the Guaranty Trust Assets secure the obligations of the issuer in respect of the covered bonds; (2) the Asset Coverage Test is intended to test the asset coverage of the Guaranty Trust Assets in relation to the covered bonds prior to the occurrence of an Issuer Event of Default, service of an Issuer Acceleration Notice on the Issuer and service of a Notice to Pay on the Guaranty Trustee; and last but not least (3) the Amortisation Test is intended to test the asset coverage of the Guaranty Trust Assets in relation to the Covered Bonds following the occurrence of an Issuer Event of Default, service of an Issuer Acceleration Notice on the Issuer and service of a Notice to Pay on the Guaranty Trustee.

If an Issuer Event of Default occurs then, for so long as such Issuer Event of Default is continuing, (i) no further covered bonds may be issued and (ii) following service of a Notice to Pay on the Guaranty Trustee, the Guaranty Trust Available Funds will be dedicated exclusively to the payment of interest and repayment of principal on the covered bonds and to the fulfilment of the obligations of the Issuer to the other Creditors in accordance with the Guaranty Trust Priority of Payments.

All covered bonds issued from time to time will rank pari passu with each other in all respects. If an Issuer Event of Default occurs in respect of a particular Series of covered bonds, then, following the service of an Issuer Acceleration Notice, the covered bonds of all Series outstanding will accelerate at the same time against the Issuer but will be subject to, and have the benefit of, payments made by the Guaranty Trustee under the Guaranty Trust Agreement (following service of a Notice to Pay on the Guaranty Trustee). Payments by the Cash Manager on behalf of Guaranty Trustee under the Guaranty Trust Agreement in relation to such covered bonds will continue to be required to be made on their Original Due for Payment Date. If a Guaranty Trust Event of Default occurs, following service of a Guaranty Trust Acceleration Notice, the Covered Bonds of all Series outstanding will accelerate against the Issuer (if not already accelerated following an Issuer Event of Default) and the obligations of the Guaranty Trustee under the Guaranty Trust Agreement will also accelerate against the Guaranty Trustee.

In order to ensure that any further issue of covered bonds under the Programme does not adversely affect existing holders of the covered bonds, the Asset Coverage Test will be required to be met both before and after any further issue of covered bonds and, on or prior to the date of issue of any further covered bonds, the Issuer will be obliged to obtain written confirmation from the Rating Agencies that such further issue would not adversely affect the then current ratings of the existing covered bonds. Nevertheless, there can be no assurance that any further issuances will not adversely affect existing holders of the covered bonds.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Global Bank's covered bonds are neither UCITS Art. 52(4)-compliant nor CRR Art 129-compliant as Panama is not a Member State of the European Union. In addition, Panama does not have national covered bond legislation. Therefore, the covered bonds do not benefit from a preferred risk-weighting for regulatory capital purposes under EU rules. Under the Standardised Approach, they are treated similarly to senior unsecured bank debt.

As Panama is neither a member state of the European Economic Area nor a G10 country, Panamanian covered bonds are not eligible for the European Central Bank repo operations conditional regardless of their currency and their rating.

> Figure 1: Covered Bonds Outstanding, 2003-2012, EUR m

Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2012, EUR m

Source: EMF/ECBC

3.24 POLAND

By Agnieszka Tułodziecka, Polish Mortgage Credit Foundation,
and Piotr Cyburt, BRE Bank Hipoteczny

I. FRAMEWORK

The legal basis for covered bond issuance in Poland is "Act on mortgage bonds and mortgage banks" of August 29, 1997; Journal of Laws no. 99, item 919 (List Zastawny Act – hereafter: LZ Act). There is also a special chapter concerning bankruptcy of mortgage banks in the new Bankruptcy Act - *Article 442 – Article450* - Bankruptcy and Reorganisation Law of 28 February 2003.

II. STRUCTURE OF THE ISSUER

The issuer is a specialised mortgage bank, licensed by the National Bank of Poland.

A mortgage bank may only engage in the activities specified in the LZ Act.

According to the Article 12 LZ Act, **the core operations** of mortgage banks include:

> Granting credits secured with mortgages;

> Granting loans not secured by mortgage, only if the borrower, guarantor or underwriter of a loan repayment to its full amount, including the interest due, is the National Bank of Poland, Central European Bank, governments or central banks of the European Union states, Organisation for Economic Cooperation and Development, excluding those countries, which are or have been for the past 5 years restructuring their foreign debt, or by means of a guarantee or security granted by the State Treasury;

> Acquisition of other banks' receivables on account of loans granted by them, secured by a mortgage and receivables on account of credits not secured by a mortgage, granted to the entities of the local self-government;

> The issue of mortgage bonds the base of which constitute the Bank's receivables on account of the granted loans secured by a mortgage or purchased receivables of other banks on account of the loans granted by them secured by mortgage;

> Issuing public mortgage bonds on the basis of:

a) the mortgage bank's receivables arising from its credits not secured by mortgages referred to in the second bullet (above);

b) purchased receivables of other banks arising from their credits not secured by mortgages referred in he second bullet (above).

According to the Article 15 LZ Act, **apart from core operations** referred to in Article 12, mortgage banks may engage in the following activities:

> Accepting term deposits;

> Taking credits and loans;

> Issuing bonds;

> Safekeeping securities;

> Purchasing and taking up shares and stocks of other entities whose legal form limits the liability of a mortgage bank to the sum invested insofar as it helps the performance of activities of a mortgage bank, where the total value of purchased or taken up shares and stocks may not be higher than 10% of the mortgage bank's equity;

- Keeping bank accounts for servicing investment projects financed through credits granted by a mortgage bank;
- Providing consulting and advice with respect to the property market, including help in establishing the mortgage lending value of the property;
- Managing receivables of a mortgage bank and other banks arising from credits referred to in Article 12 LZ Act, as well as granting these credits on behalf of other banks on the basis of relevant cooperation agreements.

All the listed activities may be executed also in foreign currencies upon obtaining relevant authorizations.

Under the LZ Act, the range of activities that can be performed by mortgage banks is specified in a closed catalogue as mentioned above. Particularly, mortgage banks cannot collect deposits of individual saver. The narrowing of activity of mortgage banks facilitates the development of a simplified and clear activity structure (which facilitates supervision, especially external one), the specialization of the loan division and an improvement in methods of credit risk assessment in the field of real (estate) property financing. Due to the above limitations, funds resulting from the issue of mortgage bonds are mainly used towards the financing of the lending activity.

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

III. COVER ASSETS

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

The cover register for mortgage bonds

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

There is also a provision for substitute assets, which is limited to 10% of the cover pool and comes from the asset categories below:

- In securities issued or guaranteed by the National Bank of Poland, European Central Bank, governments or central banks of European Union Member States, OECD (with the exclusion of states which are, or were, restructuring their foreign debt in the last 5 years), and the State Treasury;
- In the National Bank of Poland;
- In cash.

In addition, receivables secured by mortgages established on buildings which are in construction phase may not in total exceed 10% of the overall value of mortgage-secured receivables in the cover pool. Within this limit, the receivables secured by mortgages on construction plots in compliance with the land use plan, may not exceed 10% (Article 23 of LZ Act).

The cover register for public covered bonds

A public bond is a registered or bearer security issued on the basis of receivables of a mortgage bank arising from:

- Credits within the secured part with due interest, a guarantee or surety of the National Bank of Poland, the European Central Bank, governments or central banks of the EU Member States, the Organisation for Economic Cooperation and Development, except for states which are currently in the process of restructuring of restructured their foreign debts during the last 5 years, as well as a guarantee or surety of the State Treasury in accordance with provisions of separate laws; or

- Credits granted to entities listed in the point above; or
- Credits in the secured part with due interest, a guarantee or surety of local government units and credits granted to such local government units.

In regard to collateral location, mortgage collateral is restricted to mortgages against the right of perpetual usufruct or the right of ownership to a property situated in Poland are eligible for the cover. For public covered bonds, there is a wider scope and includes the following countries and institutions as eligible for the cover: National Bank of Poland, the European Central Bank, governments or central banks of the EU Member States, the OECD, except for states which are currently in the process of restructuring of restructured their foreign debts during the last 5 years, as well as a guarantee or surety of the State Treasury.

IV. VALUATION AND LTV CRITERIA

The mortgage lending value of real estate is determined under the LZ Act. The mortgage lending value of real property is determined prudently, with due diligence, on the basis of an expert opinion prepared by the mortgage bank or entities with appropriate real estate appraisal qualifications commissioned by the mortgage bank. The mortgage lending value cannot be higher than the market value of the real estate.

There are special banking supervisory regulations, which stipulate in details the assessment of the mortgage lending value and impose on the bank a duty to have a database for real estate prices.

The LTV limits are as follows:

- Single Loan to Value of Security limit: not more than 100% of mortgage lending value (Art 13.2 LZ Act)
- Value of Security limit, relating to the single loan: max. 60% of the mortgage lending value, to fund eligible assets (Art 14 LZ Act: *Funds raised from the issue of mortgage bonds may be used by a mortgage bank for refinancing mortgage-secured credits and purchased receivables of other banks arising from their mortgage-secured credits; the refinancing may not, however, exceed 60% of the mortgage lending value of the property*)
- Absolute portfolio Loan to Value of Security limit: (Art 13.1 LZ Act: *The total amount of receivables from granting credits secured with the mortgages or purchased receivables of other banks arising from their mortgage-secured credits, in the part above 60% of the mortgage lending value of the property, may not exceed 30% of the total sum of the mortgage bank's receivables secured with mortgages*).

V. ASSET-LIABILITY MANAGEMENT

According to the article 18 of the LZ Act:

- The total nominal value of all outstanding mortgage bonds shall not exceed the sum of nominal amounts of the bank's receivables secured with mortgages, which form the basis for the mortgage bond issue.
- The bank's income from interest on its mortgage-secured receivables, referred to in the point above, may not be lower than the amount of the bank's payable interest on outstanding mortgage bonds.

The Act also ensures a suitable monitoring, according to the Article 25: A mortgage bank shall keep a mortgage cover account to ensure compliance, in the long term perspective, with the requirements referred above.

Additionally, according to the internal policy of each mortgage bank, the internal limits are set using management's experience in a development bank as reference.

VI. TRANSPARENCY

The information of the activity of the Polish mortgage banks can be found on the Polish Mortgage Credit Foundation's website: www.ehipoteka.pl.

The range of data published on a yearly basis includes: new issues of covered bonds, outstanding covered bonds (mortgage & public), total assets of mortgage banks and residential & commercial property credits' sale.

Detailed information on the covered bonds issues can also be found on the issuers' websites:
BRE Bank Hipoteczny: http://www.brehipoteczny.pl/offer/covered-bonds/our-issues
Pekao Bank Hipoteczny: http://www.pekaobh.pl/u235/navi/31467.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

According to the Article 31 LZ Act, the cover pool monitor (powiernik) maintains ongoing supervision of the management of the mortgage cover register.

The cover pool monitor should ensure that:

> Commitments pertaining to the outstanding mortgage bonds are at all times covered by the mortgage bank in compliance with the provisions of LZ Act;

> The mortgage lending value of the property adopted by the mortgage bank has been established in accordance with the regulations referred to in Article 22, paragraph 2; the cover pool monitor shall not be required to investigate whether the mortgage lending value of the property corresponds to its actual value;

> The mortgage bank observes the limits laid down in Article 18 LZ Act; the cover pool monitor shall promptly inform the Banking Supervisory Commission of any cases of non-compliance by the mortgage bank with these limits.

> The manner in which the mortgage bank keeps the mortgage cover register is in compliance with this Act;

> The mortgage bank ensures appropriate cover for planned mortgage bond issues in accordance with the provisions of this Act, and proper control of appropriate entries in the mortgage cover register.

In order to perform tasks referred to in Article 30 LZ Act, the cover pool monitor shall have the right to inspect accounting books, registers and other bank documents at any time.

In matters not regulated by the LZ Act, supervision over mortgage banks shall be exercised in compliance with the Banking Law and the regulations on the National Bank of Poland (NBP). The NBP regularly checks the cover assets.

The Banking Supervisory Commission may commission an independent expert at the expense of the inspected mortgage bank to inspection of the appropriateness of the mortgage bank's entries to the mortgage cover register. This would also including establishing the mortgage lending value of the property was in compliance with the rules referred to in Article 22, paragraph 5 LZ Act.

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

The Act of 28 February 2003 – Bankruptcy and Rehabilitation Law (Journal of Law no. 60 item 535) contains separate chapter: Chapter II - Bankruptcy proceedings for mortgage banks – Articles 442-450.

In case of bankruptcy of the mortgage Bank, the claims, rights and means referred to in Article 18.3 and 18.4 of LZ Act, recorded in the mortgage bonds cover register, shall constitute a separate bankruptcy estate, which shall serve in the first place to satisfy the claims of mortgage bond creditors; after satisfying the mortgage bonds creditors, the surplus of the assets of the separate estate shall be allocated to the bankruptcy estate.

In declaring the bankruptcy, the court appoints a curator (*kurator*) who represents the rights of covered bond holders in the bankruptcy proceedings. Before the appointment of the curator, the court seeks an opinion on the proposed curator of the Banking Supervisory Commission (Article 443.1. of the Bankruptcy and Rehabilitation Law).

The following order shall apply to the satisfaction from the separate bankruptcy estate:

> The costs of liquidation of this estate, including also the remuneration of the curator,

> The amounts due to the mortgage bonds per their nominal value,

> Interest (coupons).

In case that the separate bankruptcy estate does not fully satisfy the mortgage bondholders, the remaining balance shall be satisfied from the whole bankruptcy estate funds; with that sum the curator shall vote when the arrangement is being adopted – according to Article 449 of the Bankruptcy and Rehabilitation Law: *If the separate estate is not sufficient for full satisfaction of covered bond holders, the remaining sum is satisfied from the distribution of the funds of the bankrupt estate; with this sum the curator votes in the signing of the arrangement; he has one vote for each sum resulting from dividing the sum of all other claims of those entitled to vote by the number of creditors representing these claims. The sum earmarked for the satisfaction of covered bond holders is moved from the funds of the bankrupt estate fund to the funds of the separate bankrupt estate.*

In that case, the additional amount for satisfying the mortgage bondholders shall be transferred from the bankruptcy estate funds to the separate bankruptcy estate funds. It means that the covered bond holders get preference over other creditors.

According to the Article 446 Bankruptcy Act – The declaration of bankruptcy of a mortgage bank does not infringe maturity dates of its obligations towards covered bond holders. It means that the covered bonds do not accelerate.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

In order to apply a preferential risk-weighting for covered bonds, the instrument needs to meet the criteria of UCITS Directive and CRD.

Polish covered bonds (*list zastawny*) already fulfil the criteria of UCITS 52(4)- in December 2008, the Polish list zastawny was notified by the European Commission as an European "eligible bond" – i.e. covered bond – the instrument with a qualified collateral. In that way, the notification procedure, applied by the Polish Ministry of Finance, was finished. Polish l*ist zastawny* can be found on the EC's website.

The covered bond (*list zastawny*) falls also within the criteria of the Annex VI, Part 1, Paragraph 68 (a) to (f) of the Capital Requirements Directive (CRD).

The new requirement of LTV limit – it is fulfilled by the Polish law - see Article 14 of the Covered Bond Act:

"Funds raised from the issue of mortgage bonds may be used by a mortgage bank for refinancing mortgage-secured credits and purchased receivables of other banks arising from their mortgage-secured credits; the refinancing may not, however, exceed 60% of the mortgage lending value of the property." The limit of 60% is used for every single loan and the limit is even more restrictive than the one allowed for covered bonds by the CRD (which is 80%).

The CRD requirements were word–for–word implemented by the Polish Financial Supervision Authority – see Resolution 380/2008. Therefore it is to assume that the Polish covered bonds (*listy zastawne*) apply the preferential treatment.

Moreover, National Central Bank added covered bonds (*listy zastawne*) to the list of instruments eligible for pawn credit / repo transactions. As of April 2010, the haircut level for repo amounts to 15,0 (3M repo); 20,0 (6 M repo); 25,0 (pawn credit) – ave. maturity of covered bonds – 5 years.

In Poland, the investment regulations pertaining to the limits for covered bonds are as follows:

> Banks – no limits;

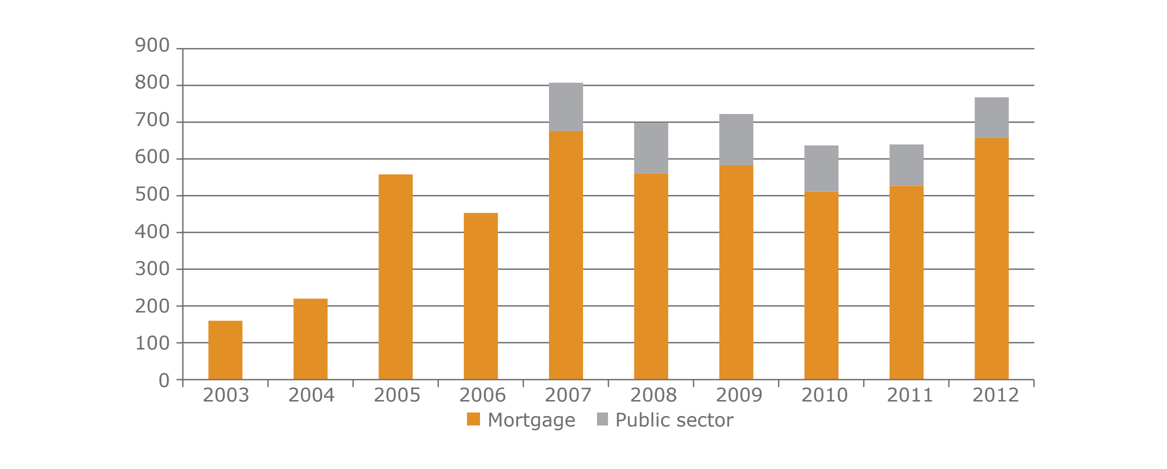
> Insurance companies – up to 40% of technical-insurance reserves – insurance companies (10% in covered bonds which were not allowed to public trading);

> Investment funds – open: 25% of the assets may be invested in covered bonds issued by one mortgage bank; but: total investments in covered bonds may not exceed 80% of the fund's assets and total value of investments in securities or in monetary market instruments, issued by the same mortgage bank, deposits in that entity, as well as the total value of risk connected with the transactions on non-standardised derivatives, which were dealt with that bank, can't exceed 35% of the fund's assets;

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

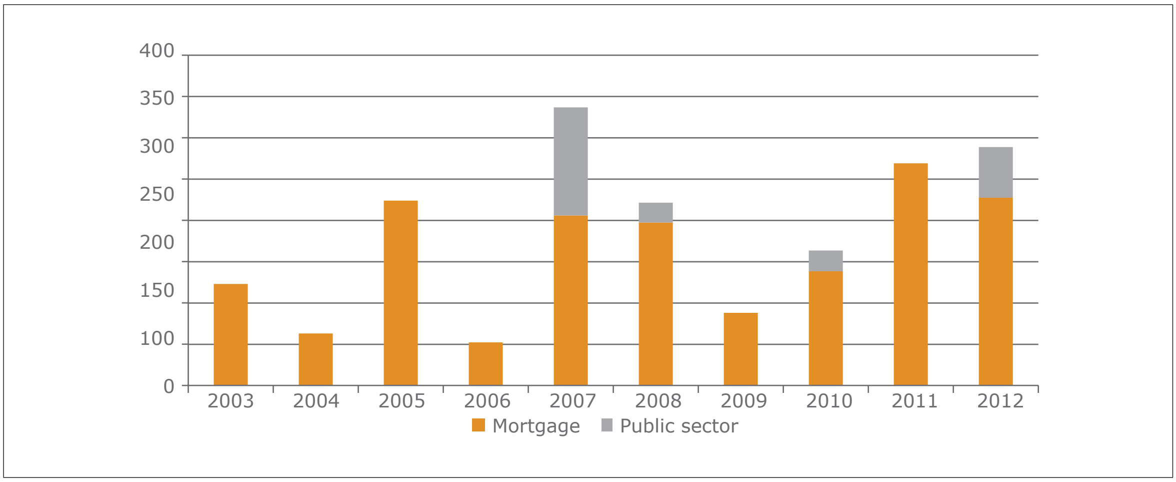
> Only the specialised mortgage banks are entitled to the issue of the *list zastawny* (the Polish covered bond). The current *list zastawny* issuers are: BRE Bank Hipoteczny S.A., BPH Bank Hipoteczny S.A. and ING Bank Hipoteczny S.A.

> Figure 1: Covered Bonds Outstanding, 2003-2012, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2012, EUR m



Source: EMF/ECBC

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/77/Polish_Covered_Bonds

3.25 PORTUGAL

By Alda Pereira, Caixa Geral de Depósitos

I. FRAMEWORK

In Portugal, the legislation on covered bonds (*Obrigações Hipotecárias and Obrigações Sobre o Sector Público*) is regulated by Decree-law no. 59/2006 of 20 March 2006 and complemented by secondary legislation - Notices and Regulatory Instruments of the Central Bank (*Avisos e Instruções*), which address issues such as the segregation of assets from the insolvent estate in case of issuer insolvency, the compliance of asset and liability matching and mortgage valuation methodology.

The exemption of withholding tax for non-resident investors for bonds issued by Portuguese entities was passed in November 2005 (Decree Law n. º 193/2005).

II. STRUCTURE OF THE ISSUER

Obrigações Hipotecárias (OH) and *Obrigações Sector Público* may be issued by credit institutions legally authorised to grant credits guaranteed by mortgages on real estate and with own funds amounting to no less than EUR 7,5 m. These credit institutions are either universal banks or special issuance entities – Mortgage Credit Institutions (MCI).

If the issuer is a universal bank, a direct issue will take place with the cover assets remaining on its balance sheet. If the issuer is a MCI, its authorised business activity is restricted to the granting and acquisition of credits guaranteed by a mortgage or loans of the central government, regional or local authorities or credits guaranteed by these entities. They may also undertake the management of assets that have been repossessed from credits in default, and undertake the activities necessary to obtain additional liquidity and adequately manage the pool.

Assuming the MCI is wholly-owned, the asset originator then transfers the cover assets to this institution and the assets and liabilities will consolidate on the originator's balance sheet. However, it is also possible for the MCI to have multiple owners and, in this case, the assets may or may not consolidate back to the originator.

Considering the MCI has a limited business activity which only makes sense within the context of covered bond issuance, one could expect the MCI to be a 100% owned subsidiary and, as such, act as a complement to the originator's business and funding activity. In this sense, it seems reasonable to expect that it could draw on the parent company's resources to operate.

However, the Bank of Portugal will always determine, on a case by case basis, the necessary conditions that must be met in order to set up an MCI.

III. COVER ASSETS

Credit mortgage loans are eligible as collateral for mortgage covered bonds i.e. credits guaranteed by first ranking mortgage loans. Second mortgage loans can be assigned to the pool if the first mortgage loan was previously assigned as well – therefore both loans are attached to the same property, provided that the total amount of these loans does not exceed the maximum Loan to Value (LTV) level permitted.

Public sector assets are eligible as collateral for public sector bonds i.e. loans granted to the central governments, regional or local authorities or guaranteed by these entities.

The Law specifies that the registration of the assets must assure mortgage credit and public sector segregation. This means that separated pools will have to be set up.

Substitution assets (up to 20%) can be included in the pool:

> Deposits with the Bank of Portugal in cash, government bonds or other eligible bonds (ECB Tier 1 assets)[1];

> Deposits in other credit institutions rated at least "A-";

> Other low risk and high quality assets – if necessary, to be defined by the Bank of Portugal.

Even thought, at first look, it would seem that OH would not meet all the requirements of the CAD since the Portuguese law allows for substitution assets up to a limit of 20% of the pool, this cannot be considered per se. In fact, Bank of Portugal's regulation establishes that the pool can only trade with credit institutions qualifying for credit quality assessment step 1 and that the aggregate risk positions cannot exceed 15% of the aggregate nominal value of the outstanding covered bonds or public sector covered bonds.

The geographical scope of eligible assets is restricted to loans guaranteed by first lien mortgages on property located in the European Union (EU) or loans granted to the central governments and regional or local authorities located in an EU member state.

Derivative contracts are permitted in the cover pool for hedging purposes, namely to mitigate interest rate, exchange rate and liquidity risks. The transactions involving derivatives, must be executed in a regulated market of a Member State of the European Union, in a legally established exchange of a full member of the OECD, or entered into with a counterparty that must be a credit institution rated "A-" or above. The legal documentation (agreement between the parties) should be standardised, however this will have to safeguard the preferential claim for the counterparty. If the currency of the issue is not in EUR, the use of exchange rate derivative contracts is mandatory in order to hedge the inherent risk of the issue.

The cover pool is dynamic while the originator is solvent and issuers are required to maintain a record of all the assets in the cover pool, including derivatives contracts.

IV. VALUATION AND LTV CRITERIA

The value of the mortgaged asset[2] is the commercial value of the real estate, considering:

> Sustainable characteristics over the long term;

> Pricing under normal market conditions;

> The peculiarities of the local market; and

> The current and alternative uses given to the mortgage asset.

The value of the mortgage asset ascertained by the issuer cannot be superior to its market value, which is the price that the object could be sold at the time the appraisal is made. This assumes that the real estate is placed on sale and that market conditions allow for a regular transmission of the mortgaged asset within an adequate timing.

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

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

1 Notice n.º 6/2006

2 Notice n.º 5/2006

> 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 EUR 500,000 for residential mortgages and EUR 1 m for commercial mortgages, the appraisal must be carried out at least every three years.

Revision of the value of an asset must be documented by the credit institution, in a clear and rigorous way, namely a description of the criteria and frequency of such a revision.

The property appraisal should be carried out by an independent appraisal specialist, with qualifications, competency and professional experience to perform this function.

The appraisal specialist is deemed not to be independent if he is in a situation susceptible of affecting his unbiased opinion, namely if he has any specific interest in the real estate being appraised or any relationship - commercial or personal - with the debtor, or if his compensation is dependent on the appraisal value of the property. The appraisal specialist may belong to the institution; however, he must have independence from the credit analysis and decision process.

The selection of the appraisal specialist by the institution must assure both diversification and rotation, and the credit institution has to maintain an updated list of the selected appraisal specialists, identifying the criteria justifying their selection and the real estate appraised by each specialist.

This list should be sent to the Bank of Portugal until the end of January of each year, reporting up to 31 December of the previous year, and indicate any changes from the last report. If there are any doubts on the performance of the appraisal specialist, the Bank of Portugal can refuse to accept the valuations, demanding the appointment of another appraisal specialist by the credit institution.

When choosing the appropriate method, the appraisal specialists should consider the specific characteristics of the real estate and its local market. The appraisal of the real estate performed by the specialist should take the form of a written report and include all the elements that allow for an understanding of the analysis carried out and conclusions arrived at.

The maximum loan to value accepted for assets to be eligible into the pool is 80% for residential mortgages and 60% for commercial mortgages loans.

V. ASSET - LIABILITY MANAGEMENT

There are various asset and liability matching requirements established in the decree-law:

> The global nominal value of the outstanding mortgage bonds cannot exceed 95% of the global value of mortgage credits and other assets at any point in time assigned to the bonds (i.e., mandatory overcollateralisation of 5.2632%);

> The average maturity of outstanding mortgage bonds can never exceed the average life of the mortgage credits and substitution assets assigned to the issues;

> The total amount of interest to be paid by the mortgage bonds shall not exceed, at any point in time, the amount of interest to be collected from mortgage credits and other assets assigned to the bonds – cash flows from the cover pool must all be sufficient to meet all scheduled payments due to covered bond holders.

The law also promotes a sound cover pool management by allowing the issuer to apply the funds (for example, funds received from early repayment) to other assets and assign new mortgages to the pool. This option allows issuers to avoid potential cash-flow mismatches. It is also possible for issuers to establish a credit facility to provide for liquidity. This credit facility counterparty is required to have a minimum credit rating of "A-".

Issuers may use derivatives contracts to hedge the interest and exchange rate and liquidity risks. The derivatives are included in the cover pool and derivative counterparties – who also benefit from preferential claim - have to be rated "A-"or above.

If the limits defined in the Decree Law are exceeded, the issuer shall immediately resolve this situation by assigning new mortgage credits, purchasing outstanding bonds in the secondary market and/or assigning other eligible assets. These will, in turn, be exclusively assigned to the debt service of the bond.

Regarding these matters, the secondary legislation[3] determines the application of the following criteria:

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

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

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

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

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

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

3 Notice n.º 6/2006

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. TRANSPARENCY

In order to provide consistent data and transparency for their issues, Portuguese covered bond issuers have developed a Common National Transparency Template based on the CBIC Template in order to ensure standardisation and comparability of the data provided by its covered bond investor reports. The Template can be found at the Covered Bond Label website.[4]

These investor reports are published on each bank´s website, encompassing specific, relevant and detailed information on the Portuguese covered bonds and the cover pools and are updated on a quarterly basis. Some issuers might not calculate some indicators according to the same criteria (for example LTV), but key concepts explanations are available for a better comprehension.

Should investors require additional financial information they deemed relevant on the Bank`s consolidated accounts or Groups Balance Sheet, they can obtain it on the respective website or directly by contacting the issuers.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

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

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

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

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

4 https://www.coveredbondlabel.com/issuers/national-information-detail/19/

5 Regulatory Instrument n.º 13/2006

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.

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

Preferential status for Portuguese covered bonds holders and bankruptcy remoteness

Holders of covered bonds benefit from special preferential claim over the assets assigned to the issue, with precedence over any other creditors - the covered bond law supersedes the general bankruptcy regulation – for the redemption of principal and payment of interest.

The mortgages that guarantee these credits prevail over any real estate preferential claims. The derivatives contracts are part of the pool and derivatives counterparties rank pari passu with bondholders in terms of preferential claim over the assets in the pool, and consequently, their contracts are not expected to be called in case of insolvency of the originator.

Despite the absence of a direct link between the cover assets and the outstanding covered bond issuance, there is a legal provision that links the cover pool to the payment of capital and interest on the covered bonds thus rendering covered bonds direct, unconditional obligations of the issuer. The issuer of covered bonds holds the claims on the cover assets and these, in turn, will guarantee the covered bonds until all payments due to bondholders have been met.

If the issuer becomes insolvent, cover assets form a separate legal estate - a pool that is to be administered in favour of the covered bondholders, and consequently there is no automatic acceleration of the mortgage bonds.

However, bondholders may convene a bondholders' assembly and may decide by a majority of 2/3 with regard to the outstanding bond volume to call the mortgage bonds, in which case, the administrator shall provide for the liquidation of the estate assigned to the issues and thereafter the payment of creditors in accordance with the provisions defined in the decree-law.

If the cover assets are not sufficient for the covered bonds, bondholders and derivative counterparties will rank pari passu with any common creditors of the issuer in relation to all other assets of the issuer (not included in the cover pool), after all guaranteed and privileged creditors have been duly paid up, for the payment of the remaining debt due to them.

Asset segregation

The assets - mortgages loans or public sector loans and substitute assets – and derivative contracts assigned to the issues are held by the issuer in separated accounts – cover register - and can be identified under a codified form. This information is deposited in the Bank of Portugal in the form of a code key. The Bank of Portugal regulates the terms and conditions by which the bondholders will have access to such key in case of default[6].

The legal effect of registration is to segregate those assets from the insolvent estate over which bondholders will have a special claim in case of insolvency/bankruptcy. In this situation the assets pledged to one or more issues of mortgage bonds will be separated from the insolvent estate for the purpose of its autonomous management until full payments due to the bondholders have been met. Despite this, the law stipulates that

6 Notice n.º8/2006

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.

IX. 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 52(4) of UCITS, a 10% risk-weighting can be applied for covered bonds issued within the scope of the Portuguese jurisdiction, as well as to covered bonds that already benefit from a 10% risk-weighting in their home country. The risk-weighting of derivatives that are included in the cover pool will be 20%. Investment funds can invest a maximum of 25% of their own funds in a single issuer’s covered bonds.

Portuguese covered bonds also meet the requirements of the Annex 6 of CRD of June 2006.

X. ADDITIONAL INFORMATION

Developments in the Portuguese covered bond market

During 2012, the European economy continued to be affected by the sovereign debt crisis, following the contagion of Italy and Spanish debt. Concerns over the worsening of public finances increased around mid-year which led several governments to reinforce austerity measures. Also, European governments and central banks continued to coordinate their measures aimed at stabilising financial markets and boosting economic activity while strengthening monetary union and this led to an improved market sentiment in the second half of the year.

The Portuguese economy continued to be influenced by the adjustment process imposed by the rescue plan negotiated with the IMF/EU/ECB with the objective of restoring sound public finances, improved competitiveness and sustainable growth. This process implied several adjustments in the economy and the banking sector by demanding higher solvency ratios and a reduction of the loans to deposits ratio.

The Portuguese government bond market improved considerably with yields in the 10 year maturity decreasing 675 basis points from a maximum value in the beginning of the year of 14.16% to a low of 7.41%. In the 5 year maturity, annual yields fell 1018 basis points from a maximum value of 15.71% to a low of 5.53%.

7 Designated Credit Institution

8 Notice n.º7/2006

In this more positive context, Portuguese covered bonds showed the strongest performance with yields in the 7 years maturity decreasing from 10.80% in the beginning of January to 5.69% in the end of December 2012 and the 3 year maturity declining from 12.18% in January to 4.44% in December 2012.

In January 2013, CGD tapped the market launching its 4th public issue under its covered bond programme, after this market was closed to Portuguese issuers for practically 3 years. The EUR 750 m issue with a 5 year maturity and coupon rate of 3.75% was heavily oversubscribed by more than EUR 4 bn. The great demand for this issue is also demonstrated by the fact that it had interests from more than 200 investors with 90% of the issue being placed outside Portugal, namely investors in the United Kingdom, Germany, Austria, France and Switzerland.

With the launch of this new issue of covered bonds, CGD reopened this market segment and also facilitated access to other Portuguese issuers.

In order to ensure maximum transparency and liquidity to its covered bond issues, Portuguese covered bond issuers adhered to the Covered Bond Label. As a part of the compliance with the Label, a common National Transparency Template was made available in each bank's website regarding specific and detailed information on the covered bond issues and their pools. As a consequence, CGD and other major Portuguese covered bonds issuers now have their mortgages issues labelled.

Notwithstanding these difficult market conditions, Portuguese covered bonds continue to enjoy one of the strongest legal and regulatory frameworks with strict rules that ring-fence the pool of assets underlying the covered bond issues from the bank balance sheet, the special preferential claim that investors enjoy over these assets with precedent over any other creditors, the clarified regime of bankruptcy remoteness and the close supervision of Bank of Portugal.

Additionally, the pools of assets have maintained average low LTV ratios and overcollaterisation at adequate levels in order to grant a considerable level of security reinforcing the safety characteristics of this asset class. In addition, Portuguese housing markets, not suffering from a speculative bubble have kept relatively stable, maintaining the high level of guarantees.

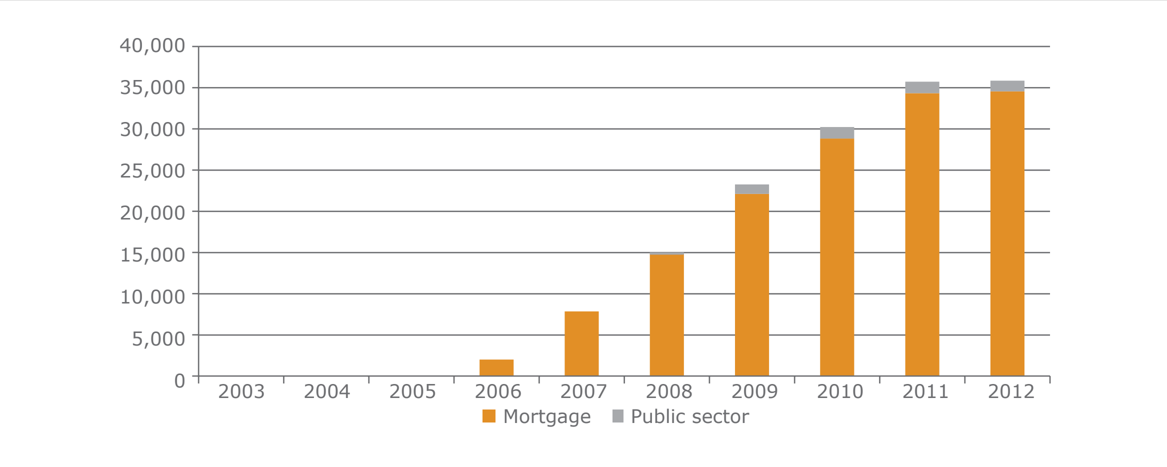
While the big fall in the interest-rates level following the introduction of the euro triggered a surge of house price inflation in Spain, nothing on the same scale occurred in Portugal. If adjusted for inflation, real price change has in fact been slightly negative in several years.

For this reason, the current price fall is less a correction of an existing market overvaluation and more the result of ultra weak demand caused by Portugal's difficult economic situation and exceptionally high unemployment. The same lack of demand is also evident in the falling volume of construction lending. The fact that new residential building has effectively come to a standstill means that net housing supply should not increase.

The recession, in a context of high level of unemployment and the government looking for further austerity options is likely to keep prices falling during 2013. However, the rate of price decline could slow given the size of the correction that has already taken place.

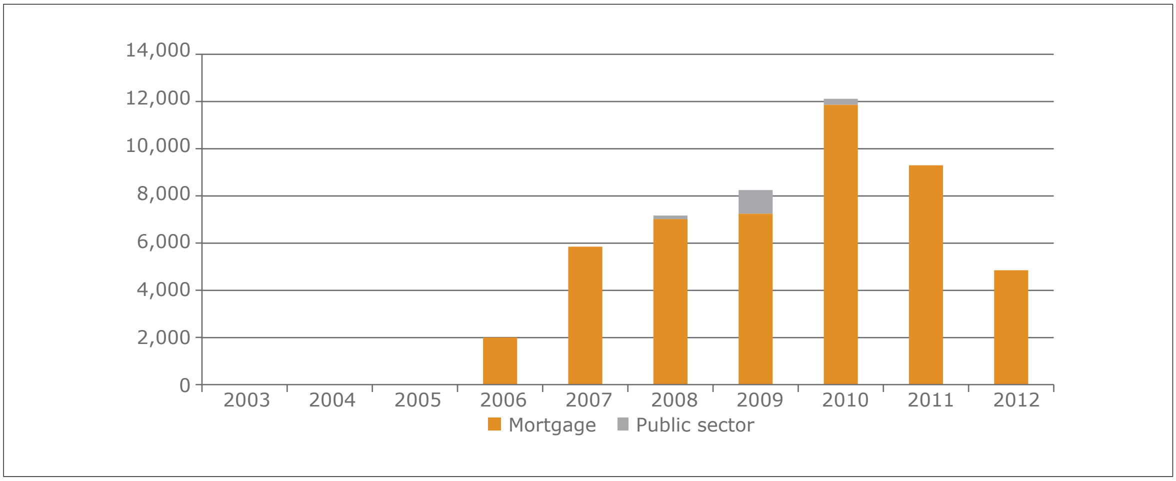
By December 2012, both Obrigações Hipotecárias and Obrigações sobre o Sector Público combined have achieved an outstanding amount of EUR 35.9 bn of issues with a residual weighted average tenor of 3.9 years.

> Figure 1: Covered Bonds Outstanding, 2003-2012, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2012, EUR m



Source: EMF/ECBC

Issuers: There are 6 active issuers in Portugal: Milleniumbcp Banco Comercial Portugues, Banco Espirito Santo, Banco Portugues de Investimento, Caixa Económica Montepio Geral, Caixa Geral de Depositos and Santander Totta.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/38/Public_Sector_CB_%28Obriga%C3%A7%C3%B5es_sobre_o_Sector_P%C3%BAblico%29 and http://ecbc.eu/framework/39/Mortgage_CB_%28Obriga%C3%A7%C3%B5es_Hipotec%C3%A1rias%29

3.26 ROMANIA

By Irina Neacsu, Banca Carpatica, and Adrian Sacalschi, FHB Bank

I. FRAMEWORK

In Romania, the legal basis for Covered Bond issuance is the Mortgage Bonds Law from March 2006. This law supersedes the general bankruptcy regulation.

The legal framework for covered bonds is currently under revision in Romania. Below we will refer also to some important features which are under discussion with the Romanian supervisory authorities for being amended.

Since the implementation of the existing Mortgage Bonds Law no covered bonds have been issued by a local issuer.

II. STRUCTURE OF THE ISSUER

The issuer can only be a credit institution (as defined by Romanian Banking Law, which is in line with the EU Directive). Therefore, all commercial or mortgage banks may be issuers and no other special covered bond license is required.

Mortgage banks are credit institutions, but their licensing is limited since this type of credit institutions are not allowed to receive deposits. The National Bank has not yet issued the set of applicable regulations for mortgage banks. Up to date no mortgage bank as such is incorporated under Romanian Law.

Pursuant to the Mortgage Bonds Law, the issuer holds the assets on its balance sheet. The covered bond issuer holds the ownership title over the portfolio. A direct legal link between single cover assets and covered bonds does not exist. All obligations from bonds are obligations of the issuing bank as a whole. However, under the current law there is a legal link between each bond issue and its pool of cover assets. In the event of insolvency, the cover pool is segregated by law from the general insolvency estate and is reserved for the claims of holders of the specific bond issue.

Assets servicing may be outsourced, but for covered bonds it is expressly regulated only in case of the issuer's bankruptcy.

The covered bonds are direct and unconditional obligations of the issuer. The claims of the holders of covered bonds are secured by a first rank security interest over the cover assets, which are segregated in bankruptcy. Each bond issue is guaranteed by a distinct pool of assets. In the event of bankruptcy, the bonds holders in a specific issue will have first priority over the pool of assets dedicated to the specific issue.

This legislative provision regarding separate cover pools for each covered bond issue will be set aside in the amended Romanian covered bond legal framework, which is currently under preparation in Romania.

III. COVER ASSETS

In the case of covered bonds structured under the Mortgage Bonds Law, only mortgage loans (i.e. residential or commercial mortgage loans) can be included in the cover pool. The cover pool could be replenished with other mortgage loans if some of the pledged loans don't fulfil the eligibility criteria anymore. Other eligible assets (besides mortgage loans) will only be used for supplementing the cover pool if the issuer has no other mortgage loans that could be used for such a purpose. The list of these other eligible assets which can be included in a cover pool is to be established by the National Bank.

In terms of derivatives allowed to be included in the cover pool, no special provisions are contained in this respect in the Mortgage Bonds Law. However, the National Bank is entitled to regulate the categories of eligible assets that can be used for supplementing the cover pool in case the issuer has no other mortgage loans. The only restriction in this respect imposed by the Mortgage Bonds Law stipulates that the general maximum ratio allowed for supplementing the portfolio and the substitution of the mortgage loans in a cover pool with eligible assets may not exceed 20% of the portfolio value.

The mortgage loans must fulfil several eligibility or performance criteria imposed by the Mortgage Bonds Law in order to be included in the cover pool:

> The pool is homogenous comprising of only one type of mortgage loan according to its investment destination;

> The weighted average of the maturities of the mortgage loans included in the cover pool securing an issue is higher than the maturity of the mortgage bonds secured by such a cover pool; the weighted average of maturities shall be calculated by weighting the outstanding life time of the loans included in the cover pool with the nominal value of the loan as of the date of issue;

> The updated value of mortgage loans securing an issue of mortgage bonds has 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 does not 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 does not to exceed, in case of a residential mortgage loan, 80% of the reference value of the immovable asset over which the security interest was created and, in case of a 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; and

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

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

The Mortgage Bonds Law generally stipulates that the cover pool is static. The replacement of the mortgage loans included in the cover pool is prescribed as an obligation only when certain mortgage loans no longer comply with the eligibility criteria, have become non-performing in the meaning of this law or determine the reduction of the weighted average of the maturities of the mortgage loans included in the cover pool, of the value of the mortgage loans included in the pool or of the interest amount, according to the limits provided by law.

*In the amended Romanian covered bond legal framework it is intended to have only one cover pool (**a mortgage cover pool** – comprising of eligible mortgage and housing loans), which will be dynamic.*

Regarding the **disclosure requirements**, detailed information concerning the assets included in the cover pool has to be provided in the offering circular, such as: the value of the mortgage loans included in the cover pool; the reference value of the collateral created for the reimbursement of the mortgage loans as established at the conclusion of the collateral agreement against the nominal value of the issue; the interest coverage provided by the cover pool; geographical dispersion of the mortgage loans, maturity, interest, interest computational method and payment schedule as well as prepayment conditions under the respective mortgage loans.

The internal cover register shall contain detailed information on the cover pool and a separate section for registering the substitute assets included in the cover pool. The internal cover register shall be kept and filled in by the issuer with respect to any amendments or changes to the data since the initial registration.

IV. VALUATION AND LTV CRITERIA

Property valuation is regulated and is required to be undertaken by an authorized real estate appraiser. The reference for a property value is considered to be the market value as opposed to the mortgage lending value. Details about the valuation process and the qualifications of valuers are regulated by the Romanian Association of Evaluators (ANEVAR). The legal framework does not incorporate any special monitoring requirement.

The Mortgage Bonds Law stipulates limits for maximum LTVs on both commercial and residential loans at 70% and 80%, respectively. *These are absolute LTVs refer to the loans granted. No provision is made regarding a relative limit.*

The current draft of the amended Romanian covered bond legal framework stipulates a relative lending limit of 60% of the reference value of the collateral, so that mortgages may be used as cover only up to the first 60% of the value of the property. Also, it is under discussion if other LTVs ratios will be introduced (80% for residential mortgages, 70% for commercial mortgages). Only mortgage loans/housing loans with no overdue payments are accepted to be included in the cover pool. The automatic replacement of the loans in the cover pool will be done when the loans have more than 61 days overdue. A minimum overcollateralization of 2% is proposed.

V. ASSET - LIABILITY MANAGEMENT

The Mortgage Bonds Law stipulates that the net present value of the outstanding bonds must be covered at all times by the net present value of the assets and that the weighted average term to maturity of the assets should be higher than the bonds' maturity. The issuer can provide overcollateralization up to a maximum ratio of 20% of the cover pool value. *The draft of the amended covered bonds law stipulates no upper limit for overcollateralization.*

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

The amended Romanian covered bond legal framework will introduce new elements:

- Supplementary assets – up to 20% of the total assets in the cover pool may comprise of liquid receivables toward Central Bank, EU or EEA governmental securities, exposures toward international financial institutions, derivative transactions for hedging purpose (subject to specific eligibility criteria and limits);
- Details about the calculation of a stress-tested net present value, the liquidity needed and hedging with *derivatives*.

VI. TRANSPARENCY

In the current Romanian legal framework on mortgage covered bonds there are no provisions on transparency.

Under the amended legislation issuers of covered bonds would be obliged to prepare and publish quarterly reports on the total volume of the issued covered bonds and the structure of the cover pool, including the nominal value of the receivables in the pool, their residual value and the structure of maturities of the receivables in the pool.

The supervisory authorities would be entitled to draft regulations regarding the content, the terms and publication of the quarterly reports.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Under the Mortgage Bonds Law, the activity of a mortgage bond issuer is monitored by the National Securities Commission (CNVM) and the National Bank (BNR). For mortgage bonds, the law provides for the mandatory appointment of an agent. The agents have to be authorised jointly by the National Securities Commission and by the National Bank. Initially, the agent shall be appointed by the issuer from a list of agents, approved by the National Bank (mandatory pre-requisite for the issuance of mortgage bonds). Upon subscription of the mortgage bonds by the investors, the revocation/appointment of the agent shall be made exclusively by the general meeting of bondholders.

The agent's main role is to monitor the cover pool on behalf of the bondholders. Its monitoring obligations shall be performed on a monthly basis, based on the synthetic documentation provided by the issuer. The agent has to observe issuer's compliance with the law and prospectus requirements. Based on the documentation provided by the issuer, the agent shall issue a certificate attesting the issuer's compliance with the provisions of the law and with the offering curricular regarding the cover pool structure. The agent shall be jointly and severally liable towards the bondholders with the issuer, with the financial investment services company handling the sale and with the issuer's financial auditor for the damages caused by non-fulfilment of several duties provided for under the law (including the obligation to monitor the issuer's compliance with the requirements related to the cover pool).

The qualification, role and duties of the agent will be clarified in the amended Romanian covered bond legal framework.

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

A cover register allows for the identification of the cover assets for each issue. The issuer has the obligation to keep a cover register for each mortgage bond issue.

Registration in the cover register reflects the structure and dynamic of the portfolio at any time throughout the life of the issue. The cover register contains information with respect to each mortgage loan included in the cover pool (i.e. type: commercial or residential, beneficiary of the loan, immovable asset over which the security for reimbursement of the mortgage loan has been created, land book number, value of the mortgage loan and reference value of the immovable asset, any other collateral and its nominal value) and substitute assets.

Registration in the cover register triggers an obligation for the issuer to have a security interest, which is registered with the Electronic Archive and covers each and all assets registered in the register. These assets are specifically registered in the accounting books of the issuer and segregated from the estate of the issuer in the event of bankruptcy. The cover register is kept by the issuer and subject to checks by the agent and supervision by the National Bank of Romania.

Asset segregation

By registration of the security interest over the pledged cover assets and the entry into the internal cover register of the mortgage loans or other assets included in the cover pool, such assets are segregated from the other assets of the issuer. The segregation of the cover assets from the insolvent estate of the issuer is thus a consequence of a contractual pledge and the operation of the law.

After the launching of the insolvency proceedings, a special portfolio management company carries out the administration of the cover assets. The appointment of the cover pool manager is made by the general meeting of bondholders.

Impact of insolvency proceedings on covered bonds and derivatives

Mortgage bonds do not automatically accelerate when the issuing institution becomes insolvent, but the bondholders could be obliged to accept payments in advance, with the corresponding recalculation of their rights if the cash-flows in the cover pool allow that.

The amended Romanian covered bond legal framework will clarify the asset segregation provisions, set aside the de facto acceleration provision and will also clarify the regime of derivatives registered in the cover register.

Preferential treatment of covered bond holders

Mortgage bond holders enjoy preferential treatment as the law stipulates the separation of the cover assets from the insolvent issuer's estate.

In the event that the cover assets of a specific issue are not sufficient to cover the payments of that issue, the Mortgage Bonds Law provides for a cross-subsidy principle amongst different issues of cover bonds of the respective issuer if there is a surplus after payment of all the obligations towards the bondholders in a specific issue. If the cover assets are not sufficient, the bondholders have an unsecured claim towards the bankrupt estate for the difference.

A moratorium on the insolvent issuer's estate cannot delay the cash flows from the cover assets and, therefore, endanger the timely payment of covered bond holders.

A special insolvency procedure could be commenced against the cover pool only by the bondholders.

Access to liquidity in case of insolvency

After bankruptcy proceedings are opened, with the appointment of an asset management company as the cover pool administrator, the right to manage and dispose of the recorded assets is transferred to this company by law. Thus, the cover pool manager first has access to the cover assets and collects the cash flows according to their contractual maturity and pays the amounts due by the issuer to the bondholders.

There are no specific regulations expressly addressing the issue of voluntary overcollateralization in insolvency. It may be argued that voluntary overcollateralization is part of the cover pool with all legal consequences regarding segregation in the event of bankruptcy applicable to the respective pool.

The draft of the amended covered bond law stipulates minimum overcollateralization level of 2%.

Sale and transfer of mortgage assets to other issuers

A bankrupt issuer cannot be liquidated until it has assigned the cover pool to another issuer. The portfolio of assets may be sold to other issuers in a transaction concluded after the launching of the bankruptcy proceedings if the liquidator's report provides the sources from which the insolvent issuer may pay in full the amounts due to the bondholders and if the bondholders in each issue (if more than one) have decided in the general meeting of bondholders to accept payment in advance under the terms provided in the liquidator's report.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The covered bonds issued under the Mortgage Bonds Law fulfil the UCITS 52(4) criteria. The law requires such bonds to be issued by a credit institution, which is subject by law to special public supervision designed to protect bondholders (i.e. supervision by the National Bank of Romania and respectively by the National Securities Commission) and provides coverage by law of the claims attaching to the bonds in the event of failure of the issuer, on a first priority basis for the reimbursement of the principal and payment of the accrued interest.

Covered bonds under the Mortgage Bonds Law also comply with the CRD Directive Annex VI, Part 1, Paragraph 68 a) to f).

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/99/Obligatiuni_Ipotecare_-_Mortgage_Covered_Bonds

3.27 RUSSIA

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I. FRAMEWORK

One of the countries with the largest potential for mortgage securities is without any doubt Russia. The country needs large investments in building of new and renovation of existing housing[2].

It is the aim of the government, that 2015 50% of all housing mortgage loans shall be funded by mortgage obligations and other mortgage securities in 2015, 55% in 2020 and 66% in 2013[3]. Further measures to enhance housing finance and construction are foreseen in a presidential decree[4].

This article will give an overview over the legal framework for mortgage obligations. Legal bases is the Law on Mortgage Securities[5]. This law is supported by rules in the Mortgage law, the Bankruptcy law, the Credit organisations bankruptcy law and the Securities market law.

In addition the Central Bank of the Russian Federation (CBRF) issued the Mortgage cover mandatory requirements instruction[6]. The Federal Financial Markets Service (FSFR) released:

> The Mortgage cover determination order[7],

> A joint order containing (i) the Special depositor decree and (ii) the Register maintenance rules[8] and

> The Mortgage cover administrator/special depositor data reporting decree[9].

Further rules are in general regulations of the CBRF and the FSFR[10].

1 Special thanks go to the collegues from AIZhK, DeltaCredit Bank and VTB Capital for proof reading and commenting on this article. An important information source was published earlier this year: Information Agency CBonds/Rusipoteka (publ.): Encyclopedia of Russian Securitization, Moscow 2013.

2 For an overview of the development see: Khmelnitskaya, Marina: (1) Trends in home-ownership in Russia: the impact of public policy on the emerging tenure structure and the housing finance market; Housing Finance International, Spring 2013, p 32 – 39 and (2) Evolution of housing finance policy in the Russian Federation: ideas, interests, institutions – a historical overview; EMF Hypostat 2011, pp 14 – 16. Tumanov, Andrey: Affordable housing sector in Russia: Evolution of housing policy through the period of transition; Housing Finance International, Spring 2013, p 25 – 31. See as well: Lassen, Tim: Development of the Russian Mortgage Obligation Market; EMF Mortgage.Info.04 (April).2012, p 5 – 7.

3 Schedule to the "Strategy for Development of Housing Mortgage Lending in the Russian Federation until 2030", confirmed by the government's order dated 19 July 2010, no 1201-r (SZ, 2010, No 30, item 4118). Numbers for mortgage lending and dwelling completion can be found at: Lyubimtseva, Anna: Russian Mortgage Market on the Up; EMF Mortgage Info March 2012, pp 5 & 6.

4 Decree of the President dated 7 May 2012 no 600 "On measures to secure for citizens of the Russian Federation affordable and comfortable housing and increasing the quality of the housing communal services" (SZ, 2012, no 19, item 2337).

5 Federal Law dated 11 November 2003 No 152-FZ "On Mortgage Securities". Changes since 2011: (1) Federal law dated 21 November 2011 No 327-FZ (published: SZ, 2011, No 48, item 6728), (2) Federal law dated 30 November 2011 No 362-FZ (SZ, 2011, No 49, item 7040), (3) Federal law dated 25 June 2012 No 83-FZ (SZ, 2012, No 26, item 3436), (4) Federal law dated 29 December 2012 No 281-FZ (SZ, 2012, No 53, item 7606). A list of the legal framework is attached to the country report in ECBC Fact Book 2010, pp 274 – 276.

6 Instruction of the CBRF dated 31 March 2004 No 112-I "On mandatory requirements for credit organisations, issuing securities with mortgage cover". Changes since 2012: (1) Direction CBRF dated 21 January 2011 No 2569-U (Herald (Vestnik) of the CBRF No 12 (1255) dated 22 February 2011), (2) Direction CBRF dated 14 November 2012 No 2910-U (Herald CBRF No 75 (1393) dated 26 December 2012).

7 Order dated 1 November 2005 No 05-59/pz-n "On confirmation of the Decree on the method of determination of the mortgage cover". Latest change: Order of the FSFR dated 21 January 2011 No 11-1/pz-n (Bulletin of Normative Acts of Federal Executive Authorities, 2011, No 17, RegNo 20290).

8 Order dated 01 November 2005 No 05-60/pz-n "On confirmation of the Decree on the activity of the special depositar for the mortgage cover and the Rules of the maintenance of the register of the mortgage cover".

9 Order dated 15 December 2009 No 09-57/pz-n "On confirmation of the Decree on data reporting of the administrator of the mortgage cover and the Decree on data reporting of the specialised depositor of the mortgage cover". Latest change: Order of the FSFR dated 24 April 2012 No 12-27/pz-n ("Rossiyskaya gazeta", 06 July 2012, no 153; registered by the Ministry of Justice 01 June 2012, reg no 24428;).

10 Two of these general regulations have been replaced:

> Order FSFR No 06-117/pz-n/2006 by Order FSFR dated 04 October 2011 No 11-46/pz-n "On confirmation of the Decree on disclosure of information of issuers of issuing securities" (Bulletin of Normative Acts of Federal Executive Authorities, 2012, No 8, Registration number 22470); here following: Order FSFR No 11-46/pz-n/2011.

> CBRF General mandatory requirements instruction (Instruction dated 16 January 2004 No 110-I) by Instruction of the CBRF dated 03 December 2012 No 139-I „On mandatory requirements for banks" (Herald CBRF, No 74 (1392), dated 21 December 2012); here following: Instruction CBRF No 139-I/2012.

Aside from some changes to the Law on Mortgage Securities, which will be discussed here, the Russian covered bond market saw a breakthrough in rating in 2012: In December 2012 the first Russian covered bond issue was rated (issuer: DeltaCredit Bank, rated by Moody's) with a rating of two notches above the issuer's rating: Baa1 to Baa3 negative[11].

II. STRUCTURE OF THE ISSUER

The Russian Law on Mortgage Securities foresees two types of "mortgage obligations"[12] (art. 7 sec 1[13]): obligations[14] issued(i) by a credit organisation (covered bonds) or (ii) by a SPV ("mortgage agent") (MBS)[15].

Obviously the mortgage obligations issued by credit organisations, are oriented on the European covered bond model, those mortgage obligations issued by SPVs on the MBS model. As many rules in the law apply similarly for both types of securities, for a better understanding they will be presented here together.

For new issues (new series of issues) are new cover pools set up. The cover pools itself are dynamic (as defined by the ECB[16]): The cover pool for every issue can be modified in cases, stipulated by the law, to ensure that there is always enough cover for the outstanding mortgage securities[17].

Credit organisations (art 7 sec 2)

A credit organisation has to comply with the Banking law and the rules, set up by the Central Bank for credit organisations. If the credit organisation does not fulfil the statutory requirements, the licence can be revoked (art 20 sent 1 no 10 Banking law).

By pt 1.1 and 2.4 Mortgage cover mandatory requirements instruction, the CBRF has set up a special regulation[18] for the minimal ratio between the volume of the cover pool and the volume of the issued mortgage obligations (N18): 100 % (pt 1.1 sec 3 and 2.4 Mortgage cover mandatory requirements instruction)[19].

For credit organisation the excess amount of the cover pool shall not be more than 20% (art 13 para 3 sec 2).

The Central Bank has not used its right to set a special limit for mortgage obligation issuers for the interest rate and foreign exchange risk[20].

SPVs (mortgage agents, art 8)

The mortgage agents are described in detail in the ECBC Fact Book 2011, p 413. Here we will look on some changes that came into force in 2012[21].

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11 Moody's Investors Service: (i) Sector Comment: First Russian Covered Bond Rated Under Our Covered Bond Methodology, 21 January 2012; (ii) Rating Action: Moody's assignes definitive Baa1 rating to DeltaCredit Bank mortgage covered bond, 11 December 2012; (iii) Pre-Sale Report: DeltaCredit Bank Mortgage Covered Bonds, 20 November 2011. The rating was based on the qualitiy of the cover pool and the analysis of the respective Russian law.

12 Language of the law: "Obligations with mortgage cover".

13 Law citations without link are citations of the Law on Mortgage Securities.

14 A special type of mortgage obligations are "Housing mortgage obligations" (in Russian "zhilishchnaya obligatsiya s ipotechnym pokrytiem"): Their cover pool consists only of claims, secured by mortgages over housing premises (art 3 pt 5).

15 Another mortgage security under the Law is the „mortgage participation certificate" (art 17 – 31), an instrument similar to investment fund certificates. Due to their different structure in this article we will not look after them.

16 European Central Bank: Mortgage obligations in the EU Financial System, December 2008, p 7.

17 One dynamic element for already issued mortgage obligations (see ECBC Fact Book 2012, p 412) has been abolished since 1 January 2013 by deletion of art 13 sec 1 para 2 (Federal Law dated 29 December 2012 No 281-FZ).

18 On the bases of art 7 sec 2 para 2 – 4.

19 The ratios N17 and N19 have been abolished by the Federal Law dated 25 June 2012 No 83-FZ. Pt 1.1 sec 2, 3; 2.3 and 2.5 Mortgage cover mandatory requirments instruction have been accordingly abolished by the Direction of the CBRF dated 14 November 2012 No 2910-U. For details see ECBE Fact Book 2012, p 413, fn 21.

20 But issuing credit organisations have to describe the f/x and the interest rate risk in the prospectus (annex 5 pt 3.5.3.2 and 3.5.3.3 Instruction 128-I/2006). For f/x risk see: Efimova, L. G.: Bankovskoe pravo (Banking law) – Tom (volume) 1, Moscow 2010, p 88 et seq.

21 Amendments by Federal law dated 29 December 2012 No 281-FZ.

In the charter of the mortgage agent has to be stipulated the maximum number of mortgage securities' issues, this agent is founded for (art 8 sec 1 para 6).

Due to amendments to art 8 sec 1 para 3 for mortgage agents it is now explicitly allowed – what was not clear before the amendment - to borrow money under loan/credit agreements for the purposes stated in its charter (i.e. bridge financing). The more a volunteer liquidation of a mortgage agent is only allowed after repayment of all outstanding mortgage obligations (art 8 sec 4).

Protection of terms

Due to art 6 the words "obligation with mortgage cover" (in Russian "obligatsiya s ipotechnym pokrytiem"), mortgage participation certificate ("ipotechnyj sertifikat uchastiya"), mortgage cover ("ipotechnoe pokrytie"), mortgage agent ("ipotechnyj agent") and "mortgage specialized organisation" ("ipotechnaya spezializirovannaya organisatsiya")[22] may be used only for the purposes of the Law on Mortgage Securities.

III. COVER ASSETS

Eligible assets under the Russian Law on Mortgage Securities are mortgage secured claims under a loan or credit agreement, including interest (art 3 sec 1).

Eligible are also money in Russian and foreign currency, state bonds and real estate (art 3 sec 1). Real estate can only be used as cover, if it is purchased in foreclosure of a cover mortgage (art 3 sec 1; 13 sec 1 para 3).

Requirements for eligible mortgage secured claims are:

> The mortgage shall content a prohibition on sale of the mortgaged property by the mortgagor without consent of the mortgagee (art 3 sec 2 pt 2).

> The property has to be insured to the benefit of the mortgagee for the whole term of the loan to an amount not less than the mortgage secured claim (art 3 sec 2 pt 3).

> The share of mortgage secured construction claims is limited to 10% of the cover pool (art 3 sec 3 para 3). For Housing mortgage obligations mortgage secured construction claims are not eligible (art 3 sec 3 para 1 sent 2).

> Claims, secured by a second ranking mortgage are eligible, as far as they do not exceed the LTV limit of 70% (art 3 sec 3 para 2).

> In the moment of distribution (razmeshcheniye) or delivery (vydacha) of the mortgage obligations the cover can not sustain of mortgage secured claims, pledged to secure other obligations (art 3 sec 3 para 1)[23].

One asset may only be used for one cover pool (Art 3 sec 5)[24].

IV. VALUATION AND LTV CRITERIA

Due to art 3 sec 2 para 2 the LTV limit is 80% of the market value of the property. If a second ranking mortgage is used for cover, the LTV limit is 70%[25] of the market value (art 3 sec 3 para 2). In both cases, the valuation has to be made by an independent valuer[26].

The law does not contain special regulations on valuation for the purpose of mortgage securities.

22 "Mortgage specialized organization" is another allowed name for "mortgage agent" (art 8 sec 1 para 5).
23 As amended by the Federal Law dated 29 December 2012 No 281-FZ (situation before amendment see ECBC Fact Book 2012, p 414, fn 26).
24 The cover pool itself is defined in legal literature as "specific type of property", sustaining of different elements but used as unitary "other property" according to art 128 Civil code, see Efimova, Olga V.: Ipotechnoe pokrytie kak osobyy vid imushchestva [Mortgage cover as specific type of property"], Yurist No 24/2011, p 19 – 22 (p 22).
25 Including the first ranking mortgage.
26 The valuers' profession and independence of the valuer is regulated in the Valuation law.

V. ASSET-LIABILITY MANAGEMENT

The Asset-Liability Management is described in detail in the ECBC Fact Book 2012, pp 415 & 416.

Art 3 sec 4 stipulates that the amount of the cover is defined by summing up the mortgage secured claims, amount of money in the cover and value of other assets. Details are set up by the FSFR in the Mortgage cover determination order.

The following claims shall not be encounted by summing up the mortgage cover:

> No payment made on the claim for more than six month;
> Loss of the mortgage object, including if the mortgage was declared void by a court;
> Secured obligation declared void by a court;
> Bankruptcy of the debtor; and,
> No insurance of the mortgage object for more than 6 month.
> The cover asset does not fit to the general rules for eligible claims; cover assets can be replaced by other assets (art 14 para 1; art 3 sec 4).

For proper performance of the obligations under the mortgage obligations[27] the amount of the cover pool for the whole maturity of the bonds shall not be lower than the aggregate outstanding nominal value of the bonds (art 13 sec 2 para 2 sent 1). This is further defined in the Instruction 128-I/2006 of the CBRF, which foresees that the cover pool has to secure completeness of payment and timely payment[28] (pt 6.4.2 sent 8 Instruction 128-I/2006)[29].

One cover pool can secure two or more issues of mortgage obligations (art 11 sec 2 para 1; 13 sec 2). In this case the rules on calculation of the necessary cover for one issue apply similarly (art 11 sec 2 para 1). If mortgage securities are issued in several issues on the bases of one cover pool, the volume of the cover pool has to be not less than the nominal value of each tranche together with other tranches with similar or forego-ing ranks (art 13 sec 2 para 3). Among the two or more issues the issuer may define an order of priorities: The performance of claims of one issue is only allowed after proper performance of the claims of the higher ranking issue(s) (art 11 sec 2 para 2 and 3). The rule, that for all tranches at any time the cover rules are fulfilled, can be excluded for the junior tranche by the decision on the issue (art 11 sec 2 para 1; 13 sec 6)[30].

Money received from the repayment of the mortgage secured claims has to be included into the cover pool as far as this is necessary to fulfil the legal stipulations on the volume of the cover pool (art 13 sec 4). The former rule that at least 80% of the cover pool have to be mortgage secured claims (art 13 sec 1 para 2 /old) has been abolished[31]: Under the new regulation only at the moment of formation of the cover pool, it has to sustain for 100% of mortgage loans. After issuing the bonds, due to amortisation of the cover pool, this share will reduce. To avoid the consequence of necessary prepayment of the issue, and the risk that potential new cover mortgage loans will not fit to the parameters, the money from regular repayments of the mortgages has to be included into the cover pool.[32]

27 In Russian "nadlezhashchoe ispolnenie obyazatel'stv po obligatsiyam s ipotechnym pokrytiem".
28 In Russian "polnota i svoevremenost' ispolneniya obyazatel'stv po obligatsiyam s ipotechnym pokrytiem".
29 Moody's assigned a timely payment indicator (TPI) of "Very Improbable", as covered bonds under Russian law accelarate, if the issuer becomes insolvent. Due to Moody's the Law on Mortgage Securities offers limited support for timely payment to the covered bond holders, after issuer default. (Moody's Investors Service: Pre-Sale Report: DeltaCredit Bank Mortgage Covered Bonds, 20 November 2012, p 2).
30 Introduced by Federal Law dated 28 December 2012 No 281-FZ.
31 Federal Law dated 29 December 2012 No 281-FZ.
32 See pt 5 Explanatory Memorandum of the authors of the draft dated 19 August 2011.

The mortgage securities' holders have the right to claim for prepayment of the mortgage obligations in the following cases (art 16 sec 1): Breach of the rules regarding

> Volume of the cover pool;
> Replacement of cover assets;
> Proper fulfilment of obligations under the mortgage obligations;
> The issuer is active in fields not allowed for it; and,
> Other reasons stipulated by the decision on issuing mortgage obligations.

A time frame to claim for prepayment has to be set up in the decision of the issue and shall not be less than 30 days from discovery or disclosure by the issuer of the prepayment right to the mortgage securities' holders (art 16 sec 3 sent 1). After this term the right to claim for prepayment ends (art 16 sec 1 sent 2). If the prepayment right arose in connection with a breach of the rules for the volume of the cover pool and/or the proper fulfilment of obligations under the mortgage securities as described in art 13, the right to claim a prepayment ends on the date of discovery or disclosure of information by the issuer of elimination of the breaches (art 16 sec 3 sent 2).

The issuer has to inform the mortgage securities' holders, that the right to claim for prepayment has arisen, the value of the securities, the procedure of prepayment and the termination of this right (art 16 sec 2).

VI. TRANSPARENCY

The Law on Mortgage Securities stipulates a wide range of publishing information on the mortgage obligations by the issuer (art 37 – 41). In addition to the main rules according to the Securities market law (art 37 para 1; 40 sec 1) an important information is an account report on performance of the cover assets (art 40 sec 4 para 2). Credit organisations issuing mortgage obligations have special reporting duties to the Central Bank (art 7 sec 1 para 3; pt 3.1 – 3.5 Mortgage cover mandatory requirements instruction).

Main points for publishing information are:

> If the mortgage obligations are rated by a rating agency, this rating has to be published (art 37 para 2).
> Interested persons have the right to get knowledge of the cover register (art 39 para 1)[33].
> The regulators set up further special rules for mortgage obligation issuers in the general regulations on disclosure of information[34].

The transparency rules are described in detail in the ECBC Fact Book 2012, pp 417 & 418.

VII. COVER POOL MONITOR, COVER REGISTER AND BANKING SUPERVISION

Cover pool monitor

The cover pool is controlled by a cover monitor (the "specialized depositor of the mortgage cover"[35]), art 33 sec 1. The cover monitor has to be a commercial organisation[36], licensed for (i) activity as special depositor for investment funds, share investment funds and non-state pension funds as well as for (ii) performance of depositary activities on the securities' market (art 32 para 2). The FSFR has published the Special depositor decree.

The duties and tasks of the Cover Pool Monitor are described in the ECBC Fact Book 2012, pp 418 & 419.

33 The cover register contains information on the mortgage claims on the loan-level basis (art 5).
34 FSFR: Order No 11-46/pz-n/2011 and Order No 07-4/pz-n/2007. Central Bank: Instruction No 128-I/2006.
35 In Russian "spetsializirovannyj depozitariy ipotechnogo pokrytiya".
36 Not affiliated with the issuer (art 33 sec 3 para 2).

Cover register

Cover assets have to be registered in a "register of mortgage cover"[37] (art 5). The FSFR has adopted Register maintenance rules[38].

Details are described in the ECBC Fact Book 2012, pp 419 & 420.

Supervision

State regulation of issuing mortgage securities is done by the FSFR in co-ordination with the Central Bank of the Russian Federation (art 42).

Banks, issuing mortgage securities, are supervised by the Central Bank (art 7 sec 2) and mortgage agents by the FSFR (art 43 sec 2).

Issuing of mortgage obligations

For details of this process see ECBC Fact Book 2012, pp 420 & 421.

For issuing securities, Russian law foresees a four step process[39]: (i) Decision on issue[40], (ii) state registration of issue[41], (iii) placement of securities and (iv) state registration of the report or notification on results of the issue[42]. For these general steps, the FSFR and the CBRF set up special requirements for the issue of mortgage securities. The rules for a prospectus are changing due to changes in the Securities' market law.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF MORTGAGE OBLIGATIONS

The claims of the mortgage securities' holders are secured by a pledge over the cover pool (art 11 sec 1).[43]

Asset segregation

In case of bankruptcy the cover pool is excluded from the bankruptcy estate of the issuer (art 16.1 para 1 Law on Mortgage Securities; 131 sec 2 para 3 Bankruptcy law; art 50.35 sec 2 and 4 Credit organizations bankruptcy law).

The insolvency administrator is obliged to open two special bank accounts for the cover pool to collect the money paid on the mortgage secured claims or from realization of these claims and to make payments to the mortgage obligations' holders (art 133 sec 4 Bankruptcy law). A special administrator of the cover pool, different from the insolvency administrator of the general bankruptcy estate is not foreseen.

Impact of insolvency proceedings on Mortgage obligations

The Law on Mortgage Securities stipulates two possibilities of realization of the cover pool in case of bankruptcy of the issuer (art 16.1 para 2):

> Change of the issuer ("zamena ėmitenta obligaciy s ipotechnym pokrytiem"): The cover pool will be sold with the obligation for the buyer to fulfil all conditions of the decision on issuing the mortgage obligations. Details have to be stipulated by a federal law. This federal law has not been enacted yet.

> Selling of the cover pool ("prodazha ipotechnogo pokrytiya"): The cover pool assets will be sold and the money received will be distributed among the mortgage obligations' holders. The mortgage obligations accelerate.

37 In Russian "reestr ipotechnogo pokrytiya".
38 The "register" contains information on loan-level basis.
39 Pt 2.1.1 Order FSFR No 07-4/pz-n/2007.
40 The decision sustains of two parts: Taking the decision and approval of the decision.
41 Based on the Decision and the prospectus.
42 In Russian: (i) "Reshenie o vypuske" (sustaining of: "prinyatie resheniya" and "utverzhdenie resheniya", (ii) "gosudarstvennaya registraciya vypuska", (iii) "razmeshchenie obligaciy", (iv) "gosudarstvennaya registraciya otchëta ob itogakh vypuska".
43 For questions regarding bankruptcy of an issuer see: Pervova, Ekaterina: Balansovaya sek'yuritizatsiya: yuridicheskiye riski; Korporativnyj yurist, No 5, 2013, p 22 – 25.

Preferential treatment of mortgage obligations' holders

Mortgage obligations' holders enjoy preferential treatment as the Russian law stipulates the separation of the cover pool from the general insolvency estate of the issuer (art 16.1 para 1 Law on Mortgage Securities).

In case they are not satisfied in the realization of the cover pool, the mortgage obligations' holders may ask for satisfaction from the general bankruptcy estate of the issuer (art 16.1 sec 1 para 3).

They are also enjoying a preferential treatment against deposit holders, as the cover pool – securing mortgage obligations – is excluded from the general bankruptcy estate, which in turn secures depositors on preferential bases[44].

For details to Access to liquidity in case of insolvency and Sale and transfer of mortgage assets to other issuers see ECBC Fact Book 2012 p 423. For Enforcement into the cover pool see ECBC Fact Book 2012, p 423 and ECBC Fact Book 2011, pp 342 & 343.

IX. INVESTMENT REGULATIONS

The EU investment regulations for mortgage obligations are not transferred into Russian law. Nevertheless different investment rules and privileges for mortgage securities do exist. In any case the investment rules are always including further requirements for mortgage securities to be eligible for investment[45] and the CBRF's Lombard list[46]. For Taxation and Purchase Programs for Mortgage Obligations, see ECBC Fact Book 2012, pp 426 – 429.

X. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION; ECBC LABEL CONVENTION

Russian mortgage obligations (mortgage obligations, issued by credit organisations) comply with the requirements of art 52 sec 4 UCITS and the ECBC Label Convention (see ECBC Fact Book 2012, pp 424 & 426). Mortgage obligations still enjoy a privileged risk weighting compared to other non-public securities: Mortgage obligations are weighted with 100% instead of 150%[47].

Capital Requirements Directive[48]

The CRD is fulfilled for mortgage obligations, issued by banks, where the cover pool sustains only of housing mortgage loans (e.g. Housing mortgage obligations). For mortgage obligations, secured by commercial mortgage loans, the CRD requirements (pt 68 (e)) are not fulfilled, as a loan to value up to 80% of the market value is allowed.

Annex VI, Part 1, Para 68 - 70 of the Capital Requirements Directive (CRD) 2006/48/EC

68. "Covered bonds", shall mean bonds as defined in Article 22(4) of Directive 85/611/EEC[49] and collateralised by any of the following eligible assets:

(a) exposures to or guaranteed by central governments, central banks, public sector entities, regional governments and local authorities in the EU[50];

Fulfilled. Art 3 sec 1: State bonds, issued by the Russian Federation and Russian regions.

44 See the Explanatory Memorandum of the authors dated 01 February 2011, the Official Opinion of the Government of the Russian Federation dated 6 July 2011 and the Conclusions of the Financial Markets' Committee of the State Duma as of 20 September 2011 and 24 January 2012 to draft law no 495103-5 (enacted as Federal law dated 25 June 2012 No 83-FZ).

45 For details, see ECBC Fact Book 2010, pp 269 – 271 (regarding pension funds, investment funds, insurance companies and other institutional investors).

46 For details, see ECBC Fact Book 2011, pp 343, 344.

47 See also ECBC Fact Book 2012, p 426. This privilege is also based on pt 2.3.4., Schedule 1 Designation code "8815" of the new Instruction CBRF No 139-I/2012.

48 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; published: Official Journal of the European Union L 177, 30 June 2006, p 1.

49 Now art 52 sec 4 UCITS.

50 "EU" is here understood as "national": Russian bonds instead of EU bonds.

(b) exposures to or guaranteed by non-EU central governments […];

Not applicable.

(c) exposures to institutions that qualify for the credit quality step 1 […];

Not applicable.

(d) loans secured by residential real estate […] up to the lesser of the principal amount of the liens that are combined with any prior liens and 80 % of the value of the pledged properties

Fulfilled. Art 3 sec 2 para 1: Eligible are mortgage secured loans up to 80% of the market value. The Law allows for "Housing Mortgage Obligations", covered only by loans, secured by residential real estate (art 2 para 5).

or by senior units […];

Not applicable.

(e) loans secured by commercial real estate […] and 60 % of the value of the pledged properties

*Russia: **Not fulfilled**. Art 3 sec 2 para 1; sec 3 para 2: Eligible are mortgage secured loans up to **80%** of the market value or second ranking mortgages up to **70%** of the market value.*

or by senior units […].

Not applicable.

The competent authorities may recognise loans secured by commercial real estate as eligible where the Loan to Value ratio of 60 % is exceeded up to a maximum level of 70 % if the value of the total assets pledged as collateral for the covered bonds exceed the nominal amount outstanding on the covered bond by at least 10 %, and the bondholders' claim meets the legal certainty requirements set out in Annex VIII. The bondholders' claim must take priority over all other claims on the collateral.

Not fulfilled: Art 3 sec 2 para 1: Eligible are mortgage secured loans up to 80% of the market value. Only for second ranking cover mortgages a limit of 70% is stipulated (art 3 sec 3 para 2).

Exposures caused by transmission […]; or

Not applicable.

(f) loans secured by ships […].

Not applicable.

For these purposes 'collateralised' includes situations where the assets as described in subpoints (a) to (f) are exclusively dedicated in law to the protection of the bondholders against losses.

Fulfilled: Art 16.1; 16.2 Law on mortgage securities; 131 sec 2 para 3 Bankruptcy law; 50.35 sec 2 and 4 Credit institutions bankruptcy law.

Until 31 December 2010 […].

Not applicable.

69. Credit institutions shall for real estate collateralising covered bonds meet the minimum requirements set out in Annex VIII Part 2, point 8 and the valuation rules set out in Annex VIII, Part 3, points 62 to 65.

Annex VIII Part 2, point 8:

For the recognition of real estate collateral the following conditions shall be met.

(a) Legal certainty

The mortgage or charge shall be enforceable in all jurisdictions which are relevant at the time of the conclusion of the credit agreement, and the mortgage or charge shall be properly filed on a timely basis. The arrangements shall reflect a perfected lien (i.e. all legal requirements for establishing the pledge shall been fulfilled). The protection agreement and the legal process underpinning it shall enable the credit institution to realise the value of the protection within a reasonable timeframe.

Fulfilled. Art 3 sec 6 para 1 subsec 2: The mortgage has to be registered – to be a perfected lien. Realisation of the value: See Stöcker/Stürner[51], p 60 – 81 (esp. pp 80 f.; no 25 and 26).

(b) Monitoring of property values

The value of the property shall be monitored on a frequent basis and at a minimum once every year for commercial real estate and once every three years for residential real estate. More frequent monitoring shall be carried out where the market is subject to significant changes in conditions. Statistical methods may be used to monitor the value of the property and to identify property that needs revaluation. The property valuation shall be reviewed by an independent valuer when information indicates that the value of the property may have declined materially relative to general market prices. For loans exceeding EUR 3 million or 5 % of the own funds of the credit institution, the property valuation shall be reviewed by an independent valuer at least every three years.

Fulfilled. For a privileged weighting of mortgage secured housing credits to individuals – among others - an annual re-valuation is obligatory: Instruction CBRF No 134-I/2012, annex 1, designation code "8806".

'Independent valuer' shall mean a person who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process.

Fulfilled. Art 3 sec 2 subsec 1. The valuation has to be done by an independent appraiser. Independence is defined in art 16 Valuation law.

(c) Documentation

The types of residential and commercial real estate accepted by the credit institution and its lending policies in this regard shall be clearly documented.

Fulfilled. Art. 3 sec 6 para 1 subsec 1 – Necessary are excerpts from the land register regarding the property.

The cover register itself has to contain information on the different types of cover assets (pt 3.2 Register maintenance rules).

(d) Insurance

The credit institution shall have procedures to monitor that the property taken as protection is adequately insured against damage.

Fulfilled. The property has to be insured to the benefit of the mortgagee for the whole term of the loan to an amount not less than the mortgage secured claim (art 3 sec 2 pt 3).

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51 Stöcker, Otmar M. / Stürne, Rolf: Flexibility, Security and Efficiency of Security Rights over Real Property in Europe – Volume III (Results of the Workshops of the Round Table "Security Rights over Real Property" held in Berlin 2009), 2nd revised and extended edition Berlin 2010 (vdp's - Association of German Pfandbrief-Banks - publication series, vol. 44).

Annex VIII, Part 3, points 62 to 65:

62. The property shall be valued by an independent valuer at or less than the market value. In those Member States that have laid down rigorous criteria for the assessment of the mortgage lending value in statutory or regulatory provisions the property may instead be valued by an independent valuer at or less than the mortgage lending value.

Fulfilled. Art 3 sec 2 subsec 1. The valuation has to be done by an independent appraiser. Art 3 sec 2 para 1; sec 3 para 2: Eligible are mortgage secured loans up to 80% for first or up to 70% of the market value for second ranking mortgages.

63. 'Market value' means the estimated amount for which the property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion. The market value shall be documented in a transparent and clear manner.

Fulfilled. Pt 6 FSO No 2[52]*: In determining the market value, the most likely price is, for which the object can be exchanged on an open market under conditions of competition, when the parties of the transaction are acting prudently, posses the necessary information and the amount of the price of the transaction is not affected by extraordinary circumstances.*

64. 'Mortgage lending value' […]

Not applicable.

65. The value of the collateral shall be the market value or mortgage lending value reduced as appropriate to reflect the results of the monitoring required under Part 2, point 8 and to take account of the any prior claims on the property.

Fulfilled. Art 3 sec 2 para 1; sec 3 para 2: Eligible are mortgage secured loans up to 80% of the market value of first ranking or up to 70% of the market value of second ranking mortgages.

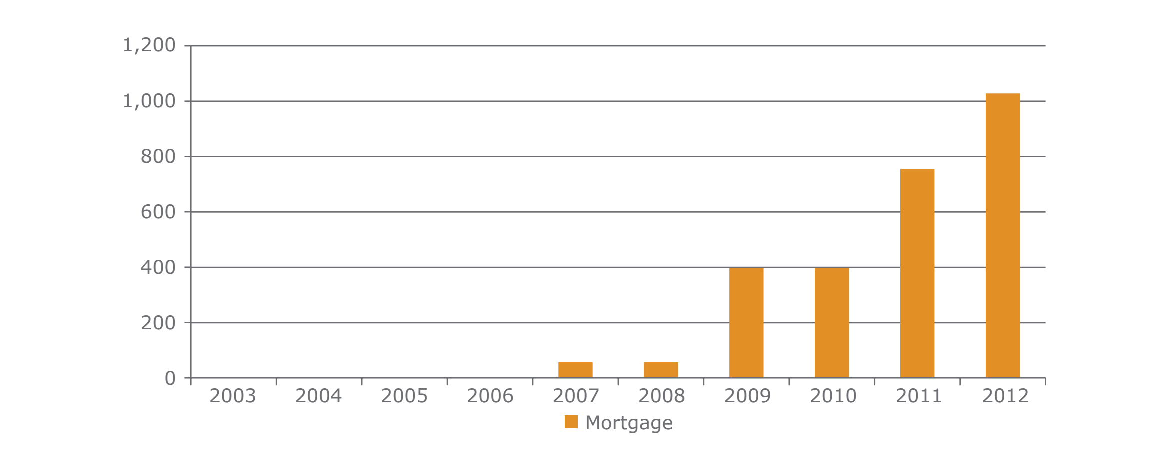
70. Notwithstanding points 68 and 69 […].

Not applicable.

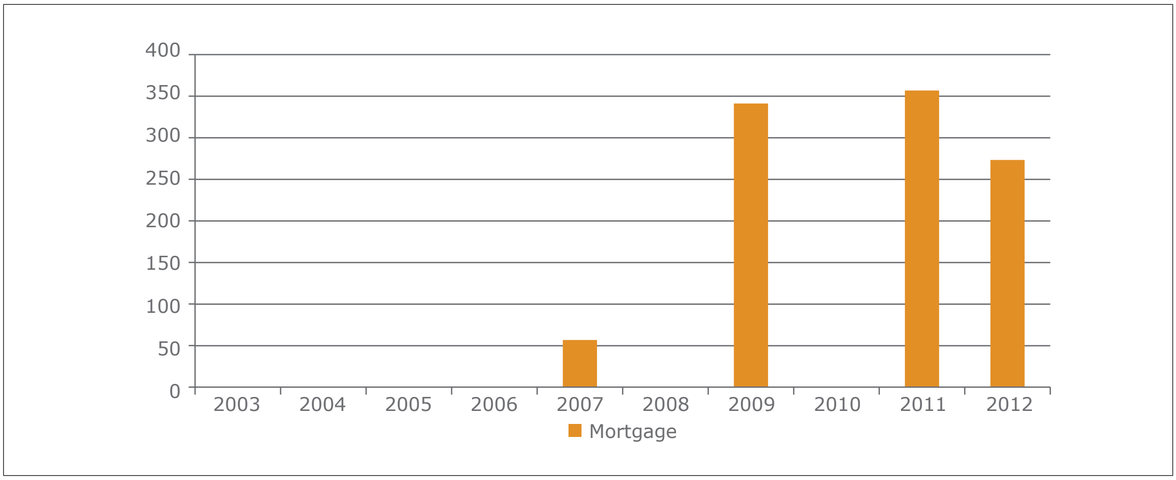
52 Order by the Ministry of Economic Development and Trade dated 20 July 2007 No 255 "On confirmation of the Federal valuation standard "Objective of valuation and types of value (FSO No 2)""; Rossiyskaya gazeta dated 04.09.2007 No 194, RegNo 10045 (23.08.2007).

XI. MORTGAGE OBLIGATION STATISTICS AND ISSUERS

> Figure 1: Covered Bonds Outstanding, 2003-2012, EUR m



> Figure 2: Covered Bonds Issuance, 2003-2012, EUR m



ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/41/Mortgage_Obligations_

> Figure 3: Overview over the issues of bank mortgage obligations (covered bonds)[53]

	Date	Issuer	Tranches	Volume		Interest	Remarks	Maturity
				mRUB	mEUR[54]			
1	11.10.07	Moscow Mortgage Agency		2,000.0	56.7	9.00% 12.5%	1-8 coupon 9-12 coupon 13-32 coupon by issuer	01.10.2015
2	16.12.09	VTB 24		15,000.0	341.3	9.70%		10.12.2014
3	14.09.11	Unicredit-bank		5,000.0	121.3	8.20%		07.09.2016
4	21.09.11	VTB 24	 A B	5,000.0 3,333.3 1,666.7	116.5 77.7 38.8	 9.00% 3.00%		26.11.2043
5	9.11.11	Delta-Credit		5,000.0	119.2	8.33%	1-6 coupon 7-10 coupon by issuer	02.11.2016
6	14.09.12	VTB 24	 A B	6,000.0 4,000.0 2,000.0	148.0 96.6 49.3	 9.00% 3.00%		15.09.2044
7	11.12.12	Delta-Credit		5,000.0	125.5	9.15%	1-6 coupon	05.12.2017
8	2.04.13	Delta-Credit		5,000.0	125.5	8.50%	1-12 coupon	02.04.2016
9	23.05.13	VTB 24	 A B	6,000.0 4,000.0 2,000.0	148.8 99.2 49.6	 9.00% 3.00%		01.09.2044
10	10.07.13	Delta Credit		5,000.0	117.3	8.65%	1-6 coupon	04.07.2018
Total				59,000.0	1,420.1			

53 Details of the issues can be found on www.cbonds.info.
54 CBRF exchange rate as of date of issue.

3.28 SINGAPORE

By Colin YS Chen, DBS Bank, and Franz Rudolf, UniCredit Bank

I. FRAMEWORK

On 9 March 2012, the Monetary Authority of Singapore (MAS) released a consultation paper on covered bonds ("Covered Bonds Issuance by Banks Incorporated in Singapore") in order to enable Singapore's banks to gain access to longer term, stable funding options as well as to facilitate the diversification of funding sources for the banking and financial markets in Singapore. The consultation paper outlines MAS' proposed rules relating to the issuance of covered bonds by banks incorporated in Singapore. At the time of writing, the final guidance on covered bonds has not been published yet by MAS, but is expected to be published in 2013.

The covered bonds will be based on contractual agreements and will be governed by the law of contracts under common law, which applies to all elements of the covered bond structure. This – together with proposed specific covered bond regulations – creates a framework comparable with that of other European jurisdictions, e.g. in the UK, via a more prescriptive regulatory framework.

Singapore's legal system is similar to the legal system in the UK in that the covered bond structure is fundamentally based on statutes or acts, which have been formally enacted by the legislative authority of the Republic of Singapore. It is considered a primary authority and source of law and determines the applicable legislation. The MAS guidelines arising from the consultation paper that is expected to be issued will provide clarity on the characteristics of a Singapore covered bond.

Singapore covered bonds will be a direct and unconditional obligation of the issuer, and in the event of a default or insolvency of the issuer, investors in the covered bond will have dual recourse: first, a senior secured claim on the pool of cover assets and second, a senior unsecured claim on the issuer. The cover pool assets will be held in a special purpose entity, which, in turn, will provide a guarantee in respect of the principal and interest payments under the covered bonds' outstanding. A bond/security trustee is appointed to hold the security over the cover pool for the benefit of the covered bond investors.

II. STRUCTURE OF THE ISSUER

MAS' consultation paper defines covered bonds as bonds, notes or other debentures issued by a bank or an SPV (Special Purpose Vehicle) where the liabilities to holders of such covered bonds are 1. recoverable from the bank and 2. secured by the assets in a cover pool. The cover pool, in this context, comprises the eligible assets beneficially owned by the bank or an SPV for the purpose of securing the liabilities to the holders of the covered bonds only. The proposal is applicable to all banks incorporated in Singapore. In order to issue covered bonds, the bank has to notify MAS at least one month prior to the issuance of covered bonds. In addition, issuers will have to submit to the MAS a Memorandum of Compliance, confirming that the guidelines with respect to the program and issuances for covered bonds have been adhered to and complied with.

III. COVER ASSETS

Eligible assets are mortgage loans secured only by residential property and derivatives held for the purpose of hedging risks arising from issuing covered bonds. MAS proposes to limit the amount of collateral in the cover pool at 2% of total assets of an issuer. For the purpose of determining the total assets of a bank, the bank shall exclude assets it uses to meet regulatory requirements under sections 38, 39 and 40 of the Banking Act, and other regulatory requirements as may be prescribed or specified by MAS. Commercial mortgage loans or public sector loans are not eligible.

IV. VALUATION AND LTV CRITERIA

The proposed legal framework sets an 80% loan-to-value (LTV) limit for the eligibility of residential mortgage loans. The LTV limit is a soft limit, meaning that in case a mortgage loan exceeds 80%, the loan can still be included in the cover pool, but only the value up to 80% is given credit to when determining the value of the cover pool. The value of the underlying collateral is determined by the most recent valuation of the residential property.

V. ASSET - LIABILITY MANAGEMENT

The consultation paper stipulates a mandatory minimum overcollateralization (OC) of 3% on a nominal basis. Further measures such as coverage tests, net present value calculations, stress-testing, substitute collateral or liquidity provisions have not been addressed in the proposal.

VI. TRANSPARENCY

No specific transparency regulations have been drafted so far.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

MAS is proposing a cover pool monitor, who has to report annually on the cover pool register, the asset limitation and the adequacy of the bank's risk management. The proposal explicitly states that the bank shall appoint an external third party, qualified to be an auditor under the Companies Act (Cap 50), as the cover pool monitor to: 1. verify annually that the bank keeps an accurate register of the assets in the cover pool; 2. verify annually that the bank complies with covered bond-specific regulations (asset cap, eligible assets, LTV limits, overcollateralization, ban of covered bond issuance through foreign incorporated entities); 3. assess the adequacy of the bank's risk management process and internal controls relating to the covered bond program annually; 4. submit a certified report to MAS annually on compliance with the covered bond guidelines; and 5. report to MAS immediately if it becomes aware that the bank has breached any of the conditions imposed.

The guideline stipulates that the issuing bank shall ensure adequate risk management processes and that internal controls are in place to manage the risks arising from the issuance of covered bonds, including appropriate governance arrangements and regular stress tests on risks arising from issuing covered bonds such as default, pre-payment, currency, interest rate, counterparty and liquidity risks. This will also include having overarching governance processes in place with respect to the authority to approve any issuance of the covered bond. Finally, the guidelines state that the board and senior management of the issuer are responsible for conducting due diligence in assessing the risks associated with issuing covered bonds and ensuring that risk management processes that are put in place for covered bonds are adhered to.

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

Given that Singapore's legal system is based on Commonwealth common law, a similar structure can be expected as used for the issuance of covered bonds in the UK, Canada, Australia, or New Zealand. Thus, covered bonds would be issued by a bank, with the cover pool collateral sold by way of an equitable assignment to a Special Purpose Vehicle (SPV). The covered bond will benefit from dual recourse on the issuer and the cover pool. This structure ensures the segregation of the cover assets from the insolvency estate of the issuer in the case of an issuer default. The contractual agreements for the issuance of covered bonds are structured within the general legislation in Singapore.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Singapore covered bonds are not UCITS 52(4) or CRD compliant given that Singapore is not a member state of the European Union. As such, it is unlikely that Singapore covered bonds will benefit from preferential risk weighting for regulatory capital purposes. However, it is expected that the guidelines will constitute a covered bond framework that broadly complies with European standards.

X. ADDITIONAL INFORMATION

The size of the Singapore mortgage market was approximately 52.1% of GDP in 2012, up from 47.0% of GDP in 2011. Home ownership is relatively high and is dominated by the public home ownership sector (Housing & Development Board; HDB). According to data from MAS, 83% of the total number of housing units in Singapore at end-2012 was related to public homes, while only 13% of the population live in or own private housing units (excluding landed housing unites). Housing loans granted rose by 16.6% to around SGD 183 bn in 2012, from about SGD 157 bn in the previous year. Owner-occupied housing loans amounted to SGD 130.7 bn, up from SGD 110 bn in 2011. The average loan-to-value ratio was 48% and the total non-performing loan ratio was 0.3% as of end-2012.

3.29 SLOVAK REPUBLIC

By Viktória Múčková and Jaroslav Sobolič, CSOB

I. FRAMEWORK

According to §§14-17 of the Act on Bonds, a mortgage bond, or *Hypotekárny Záložný* List (HZL) in Slovak, is a bond which both in terms of face value as well as in terms of interest payment is guaranteed by a claim against a bank (§ 16 Subsection 4) or a branch of a foreign bank as well as by mortgage loans secured by a pledge on real estate or through a substitute coverage (collateral) (§ 16 Subsection 5). In order to become a mortgage bond issuing institution, the respective bank has to apply for a license. The minimum amount of cash contribution to the bank's equity capital necessary to establish a mortgage bond issuing institution is SKK 1,000,000,000 (EUR 33 mn) or an equivalent amount in fully convertible foreign currency, which is twice the amount necessary to establish a non-mortgage bond issuing bank. Furthermore, the licence application has to contain details on the minimum requirements, as outlined in Section II.:

> Article 16
>
> (4) The total par value of issued mortgage bonds must be covered at least in the same amount and at least with the same yield as the par value of the mortgage bank's receivables from mortgage loans, and this shall represent due (ordinary) coverage.
>
> (5) Due coverage of issued mortgage bonds may be replaced by substitute coverage at most up to the level of 10% of the total par value of issued mortgage bonds.

> The methods of keeping a mortgage register;

> The proposal for appointment of the mortgage controller (trustee) and his/her deputy;

> The real estate assessment methods (valuation); and

> The method of keeping a separate analytical record of mortgage activities within the bank's accounting system.

As the criteria indicated in the criteria above, in order to be distinguishable from the insolvency estate of the bank, the mortgage loans serving as due (ordinary) coverage for mortgage covered bonds, just as all other items serving as substitute collateral, have to be recorded in separate mortgage (coverage) register by the issuing bank.

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

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

Within eighteen months following the effective date of mortgage business license, a bank may issue, upon a decision taken by its general meeting, temporary mortgage bonds in form of bearer securities with a total nominal value not exceeding 50% of the bank's basic capital. The bank is obliged to exchange such temporary mortgage bonds for mortgage bonds covered in accordance with § 16 Subsections 4 and 5 (full collateralisation including maximum share of substitute collateral) of the covered bond law within two years of issue thereof. The provisions of the covered bond law shall not apply in time from issue of temporary mortgage bonds until their exchange for mortgage bonds covered in accordance with the above mentioned paragraphs.

Should a bank fail to exchange the temporary mortgage bonds for mortgage bonds covered within two years following issue of relevant temporary mortgage bonds, the bank is obliged to repay such temporary mortgage bonds in their nominal value including yields for the period from issue until repayment. In practise the conception of temporary mortgage bonds has not been realised up to now.

Another specialty of Slovakian Covered Bonds lies in the fact that a covered bond issued by a specific institution terminates automatically when bought back by the issuer. Hence, activities like market making in own issues or minor price nursing is very restricted. Certainly, this is not an issue for the time being as Slovakian Covered Bonds are not heavily traded products. However, this might become an issue in the future when the euro will be the dominating predominant currency and bonds might be placed more with international investors.

II. STRUCTURE OF THE ISSUER

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

> The minimum amount of cash contribution to the bank equity capital, is SKK 1,000,000,000 (EUR 33,193,919) or an equivalent amount in fully convertible foreign currency;

> The methods of keeping a mortgage register;

> The proposal for appointment of the mortgage supervisor (trustee) and his/her deputy;

> The real estate assessment methods (valuation); and

> The method of keeping a separate analytical record of mortgage activities within the bank's accounting system.

Basic principles (rules, limits) of mortgage transactions are included in Part Twelve Mortgage Banking, Articles 67 – 88.

The issuer holds the cover assets on his balance sheet. A subsequent transfer of the cover assets to another legal entity does not take place. Given that a direct legal link between single cover assets and Hypotekárny záložný list (HZL) does not exist, all obligations relating to HZL are obligations of the issuing bank as a whole, to be paid from all the cover assets of the issuer.

III. COVER ASSETS

Slovak covered bonds benefit from coverage in the form of original collateral as well as substitute collateral. The latter must not exceed 10% of the total nominal value of mortgage bonds issued. The definition of ordinary collateral is based on the definition of mortgage loans stipulated in Art. 68 of the Slovak Banking Act Nr 483/2001. According to this article, a mortgage loan is defined as a loan with a maturity of at least four years and a maximum of thirty years, secured by the right of lien established upon a domestic real estate, (including on an uncompleted unfinished construction, which is at least to the amount of 90% complete), ***unless this Act requests otherwise***, financed by the issue and sale of mortgage bonds by a mortgage bank pursuant to the Slovak covered bond regulation. *The National Bank of Slovakia may, by its decision issued on the basis of an application of mortgage bank for reasons worthy of special attention maximum for a maximum period of two years stipulate special conditions for financing of mortgage and municipal loans, **at least 70 %**, even repeatedly. A reason worthy of special attention is in particular an attempt to maintain the stability of the financial sector.*

The loan in question is supposed to finance one of the following items:

> Acquisition of domestic real estate or any part thereof;

> Construction or modification of existing structures;

- > Maintenance of domestic real estate; or
- > Repayment of an outstanding loan drawn for purposes above;
- > Repayment of an outstanding loan drawn for purposes mentioned above.

In order to be eligible for collateral (coverage) purposes, the LTV of a mortgage loan is capped at 70%. A bank may grant loans also above this limit, however, the total amount of loans with LTV ratios larger than 70% are capped at 10% of the total amount of mortgage loans granted by the bank. These mortgage loans do not serve as mortgage bonds coverage, and therefore, the part above 70 % reduces relevant cover pool. A mortgage loan may not be secured by a lien on the real estate, on which a lien has already been established and continues in favour of a third party. As already indicated, substitute collateral may be used up to a share of 10% of the total nominal value of issued covered bonds. The following property values belonging to the mortgage bank may be used for the substitute coverage:

- > Deposits in the National Bank of Slovakia;
- > National Bank of Slovakia bills;
- > Deposits in banks with registered offices in the Slovak Republic;
- > Deposits in branches of foreign banks in the Slovak Republic;
- > Cash;
- > Treasury bonds;
- > Treasury bills; and
- > Covered bonds issued by another bank;

It is important to note that neither ABS nor derivatives qualify for the cover pool.

IV. VALUATION AND LTV CRITERIA

Property valuation is regulated in the Act on Banks, Article 73: (1) For the purposes of this Act, the value of real estate shall be determined by a mortgage bank on the basis of an overall assessment of the real estate concerned. In determining the value, the mortgage bank may only take into account permanent features of the real estate and benefits that can be derived by the owner from the real estate in the long run. For real estate burdened by a lien or transfer restrictions in accordance with Article 74, paragraph 2, a mortgage bank shall lower the value of the real estate by the amount of claims guaranteed by such lien or transfer restrictions. Article 73 (2) A mortgage bank shall only be bound by its own valuation of real estate.

Monitoring requirements result from the Decree of the National Bank of Slovakia of 13 March 2007 on banks' own funds of financing and banks' capital requirements and on securities dealers' own funds of financing and securities dealers' capital requirements, Article 110, letter a) – d):

a) Legal certainty exists, meaning that the bank's right arising under an agreement on establishing a lien or under an agreement on pledging a right or assigning a receivable is enforceable in all jurisdictions relevant in regard to the collateralising and payment function of the respective credit protection;

b) The property values are monitored, meaning that the value of the property is monitored on a sufficiently frequent basis and at a minimum once every once every three years for residential real estate. More frequent monitoring is carried out where the market is subject to significant changes in market conditions. Statistical methods may be used to monitor the value of the property and to identify property that needs revaluation. The property valuation shall be reviewed by an independent valuer when information indicates that the value of the property may have declined materially relative to general market prices.

For loans exceeding EUR 3 million or 5% of the own funds of the bank, the property valuation shall be reviewed by an independent valuer at least every three years.

c) The types of residential real estate accepted by the bank under its lending policy are documented;

d) Procedures are in place to monitor that the property taken as collateral (or the object of a pledged right) is adequately insured against damage.

For both commercial and residential property, the LTV limit is 70% of the mortgage lending value of the property. This LTV is a relative limit, i.e. when the loan exceeds the 70% limit, the part of the loan up to 70% LTV remains eligible for the cover pool. Over this limit a bank may grant mortgage loans exclusively if their total value does not exceed 10% of the total amount of mortgage loans granted by the bank.

V. ASSET-LIABILITY MANAGEMENT

Article 16 (4) of the Act on Bonds stipulates that the total volume of HZL outstanding must be covered at all times by assets of at least the same amount and with at least the same interest income. Thus, the nominal value of the cover assets must permanently be higher than the respective total value of the HZL and the interest yield must be at least the same.

Cash flow mismatch between cover assets and cover bonds is furthermore reduced by the prepayment rules applicable to fixed interest rate mortgage loans. Prepayments of mortgages during fixed rate periods are only permitted in cases of 'legitimate interest' of the borrower or after a period of the fixation term (This is a part of loan agreement). If the mortgage is prepaid, the borrower has to compensate the damage of the lender caused by the prepayment.

VI. COVER POOL MONITOR AND BANKING SUPERVISION

A cover pool monitor (mortgage trustee, mortgage controller) supervises the cover pool. He/she is appointed by the National Bank of Slovakia (central bank) and must possess the expertise and experience necessary to fulfil all duties. A mortgage controller or his deputy may only be a natural person who has the necessary professional competence and integrity to carry out this activity. A natural person with completed university education, who has at least five years experience in economics or law in the banking sector, shall be deemed professionally competent. A person shall be deemed to have the necessary integrity if he has not been lawfully sentenced for a criminal offence committed in the discharge of a management office or any intentional criminal offence.

Article 80, Act on Banks:

1) A mortgage controller shall supervise the issuance of mortgage bonds and municipal bonds with regard to their particulars and coverage pursuant to a separate regulation.

2) Prior to each issue of mortgage bonds or municipal bonds, a mortgage controller shall be obligated to issue a written certificate testifying that they are covered in accordance with a separate regulation, and that an entry was made in the register of mortgages.

3) A mortgage controller shall check whether a mortgage bank provides mortgage and municipal loans, including their securing through mortgage and whether a mortgage bank meets its obligations in respect of the mortgage register in accordance with this Act and other generally binding regulations.

4) If requested by a mortgage bank, a mortgage controller shall be obligated to assist in activities related to the performance of mortgage operations, which could not be completed by the mortgage bank without his assistance.

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

A cover register permits the identification of the cover assets. The register records the cover assets being used to cover HZL. A list of mortgage and municipal loans and their amounts, liens and claims of a mortgage bank under mortgage and municipal loans that serve to cover mortgage and municipal bonds, or other assets serving as substitute coverage, must be kept separately by a mortgage bank in its *register of mortgages* (Article 76 paragraph 1, Banking Act). The register of mortgages and the documents on the basis of which the entries have been made in the register of mortgages must be kept by a mortgage bank separately from other documents and protected against misuse, destruction, damage or loss (Article 76 paragraph 2, Banking Act). By the end of January and July of each calendar year, a mortgage bank shall be obligated to notify the National Bank of Slovakia and the Ministry of all entries made in the register of mortgages in the last six months (Article 76 paragraph 3, Banking Act). The due form and method for keeping the register of mortgages pursuant to paragraph 2 and the due form of information disclosed pursuant to paragraph 3 shall be determined in detail by the National Bank of Slovakia and the Ministry of Finance by means of a generally applicable regulation (Decree No. 661/2004 Coll. on mortgages register and details over position and activities of a mortgage trustee (supervisor)).

Asset segregation

The cover pool is a part of the general estate of the bank as long as the issuer is solvent. If insolvency proceedings are launched, the assets recorded in the cover registers are governed by the Act No 7/2005 Coll. on bankruptcy (§8, §§ 28 (2), § 50, § 67), also § 72 (3) of Act on banks. See also preferential treatment of covered bond holders.

Impact of insolvency proceedings on covered bonds

Covered bonds do not automatically accelerate when the issuing institution is insolvent, but will be repaid at the time of their contractual maturity.

Preferential treatment of covered bond holders

Privilege right of mortgage (municipal) bonds owner is specified explicitly in the Slovak relevant acts:

"Mortgage (municipal) bonds owners shall have pre-emptive security right to assets used to secure issued mortgage (municipal) bonds, including the right of lien to real estate pursuant to Act on banks (Article 74); this security right in procedure according to Act on banks, No. 483/2001 Coll., or separate regulations - for instance, Article 8, Article 28 par. 2, Articles 69 and 176 to 196 of Act No. 7/2005 Coll. on bankruptcy as amended – shall secure secured receivables of mortgage (municipal) bonds owners against the mortgage bank for the payment of the nominal value and yields upon mortgage (municipal) bonds".

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Slovak "*Hypotekárny záložný list*" fully comply with the requirements of Art. 52 (4) UCITS Directive.

Article 45 (7) and (11) of Collective Investment Act

(7) The value of bonds issued by a single bank, or by a foreign bank in a Member State which is subject to supervision that protects the interests of bondholders, may not constitute more than 25% of the value of an open-end fund's assets. Funds raised by the issue of bonds shall be invested in such assets which, until the maturity of the bonds, cover the issuer's liabilities related to the bond issue and which may, in the event that the issuer becomes insolvent, be used to redeem the nominal value of the bonds and to pay the income on them. The aggregate value of bonds acquired for an open-end fund's assets under the first sentence may not exceed 80% of the value of the open-end fund's assets.

(11) Bonds which are issued in the Slovak Republic and meet the criteria laid down in paragraph

(7) shall be deemed to include **mortgage bonds** and **municipal bonds** (municipal debt) issued by a bank which, with the funds raised from their sale, provides a municipal loan to a municipality or higher territorial fund share, and provided that these municipal bonds are guaranteed in accordance with the conditions stipulated by a separate law (Act on Bonds).

With regard to the bonds mentioned in paragraph (7) that are issued in a Member State, the management company shall take into account the similar list of bonds compiled in accordance with the law of this Member State, provided that such a list exists.

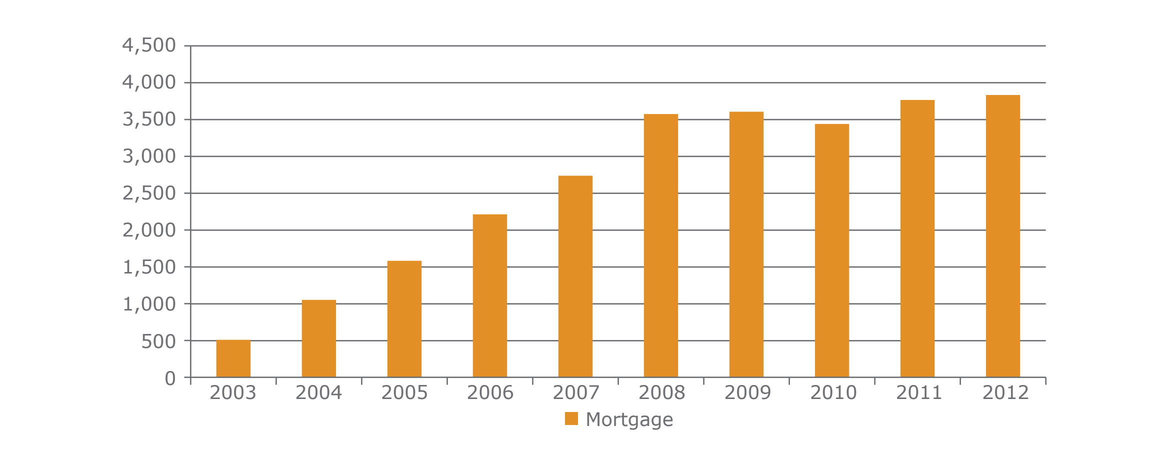
Finally, Slovak institutional investors investment legislation allows:

> Mutual funds to invest up to 25% of their assets in HZL;,

> Insurance companies up to 20 % of their technical reserves in HZL; and,

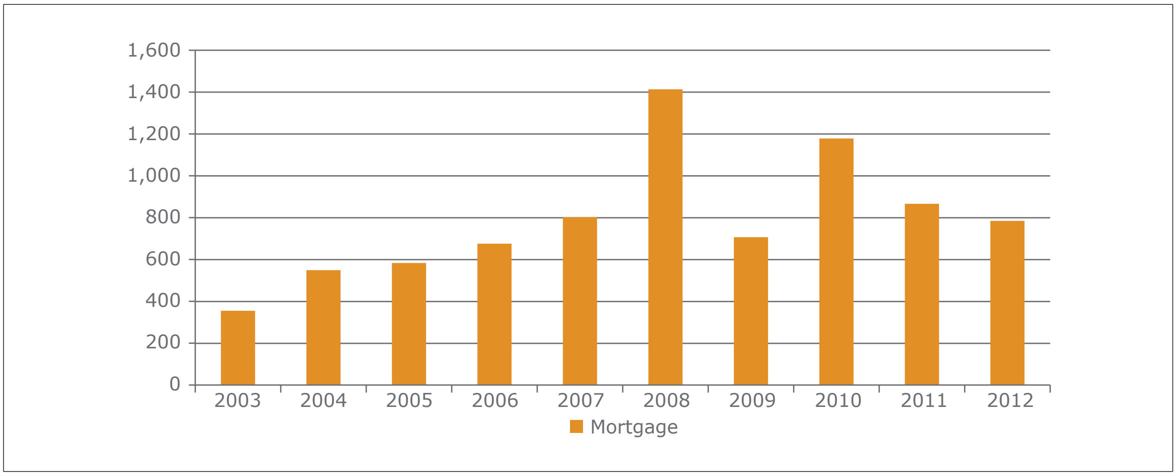
> Pension funds up to 15 % of their assets in HZL.

> Figure 1: Covered Bonds Outstanding, 2003-2012, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2012, EUR m



Source: EMF/ECBC

Issuers: There were eight issuers in Slovakia as of the end of 2012: CSOB, Dexia Banka, Istrobanka, Volksbank, OTP Banka Slovensko, Slovenská sporitelna, Tatra Banka, UniCredit Bank (Slovakia) and Všeobecná úverová Banka.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/42/Slovakian_Covered_Bonds

3.30 SLOVENIA

By Damjana Lavrič, Matjaž Grčar, Maja Koritnik;
Nova Ljubljanska banka d.d., Ljubljana

I. FRAMEWORK

The legal basis for covered bond issuance in Slovenia is the **Mortgage Bond and Municipal Bond Act** (Official Gazette of the Republic of Slovenia, No. 10/12 and No. 47/12, hereinafter "Covered Bond Act"). Together with the secondary legislation (the regulations of the Bank of Slovenia[1]) outlined below, it represents the legislative framework for mortgage and municipal bonds.

> **Regulation on the conditions for obtaining an authorisation for issuing mortgage and municipal bonds** (Official Gazette of the Republic of Slovenia, No. 17/2012) which regulates in detail the requirements for obtaining an authorisation to issue mortgage and/or municipal bonds;

> **Regulation on matching the cover pool with the outstanding mortgage and municipal bonds** (Official Gazette of Republic of the Slovenia, No. 17/12) which determines detailed rules for matching cover assets and liabilities from issued mortgage or municipal bonds based on the net present value principle, and rules for matching the maturities, interest rate and currency exposure of the cover assets with the liabilities from issued mortgage or municipal bonds;

> **Regulation on the conditions for inclusion of derivative instruments in the cover pool of mortgage and municipal bonds** (Official Gazette of the Republic of Slovenia, No. 17/12) sets out the maximum level of derivative instruments for inclusion into the cover pool, the form of derivative instruments, the type of counterparties and other detailed criteria;

> **Regulation on the documentation for proving the fulfilment of conditions for the cover register administrator appointment** (Official Gazette of the Republic of Slovenia, No. 17/12) regulates the conditions for appointing the cover register administrator[2] of a cover register and for acquiring a Bank of Slovenia's authorisation to act as the cover register administrator of a cover register.

In addition the Bank of Slovenia adopted **Guidelines for managing the records of the cover register** (Governing Board of the Bank of Slovenia, dated 28.2.2012) which set out the guidelines regarding the content, the form and the way of management of the cover register's records.

II. STRUCTURE OF THE ISSUER

The issuer of covered bonds under the Covered Bond Act can be a bank holding a valid banking license issued in accordance with the Banking Act. Further, the issuer must have obtained a license from the Bank of Slovenia for issuing the relevant type of covered bonds (i.e. mortgage bonds, municipal bonds, or both).

In order to obtain the Bank of Slovenia's license for issuing covered bonds, the issuer must prove to the satisfaction of the Bank of Slovenia that it complies with the requirements set out in Article 9 of the Covered Bond Act (detailed provisions set out in Regulation on the conditions for obtaining an authorisation for issuing mortgage and municipal bonds) as outlined below:

> The issuer must have in place systems for managing risks associated with the issuance of the mortgage and municipal bonds, as well as risks associated with cover assets;

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1 The central bank.

2 Cover register administrator is entitled to verify the accuracy and completeness of the information on the cover assets and covered bonds, measuring compliance with the statutory tests on an on-going basis and approving the entries in and removals of cover assets from the cover register.

- > The issuer must ensure an adequate number of qualified employees, be organizationally and technically qualified for issuing mortgage and municipal bonds and to grant mortgage loans, public loans and other financing to legal entities;
- > The issuer must ensure that the activities concerning granting mortgage loans and loans to public sector entities and issuing mortgage and municipal bonds are conducted separately from its other business activities;
- > The issuer must have in place rules for maintaining the cover register;
- > The issuer must have in place the rules for property valuation and must either employ for indefinite period and on full-time basis or engage contractually at least one independent property valuator.

Covered Bond Act envisages the **on-balance sheet structure of covered bonds**. The cover assets remain the property of the issuer until the insolvency of the issuer or withdrawal of the issuer's license to issue covered bonds. Upon the said events, the cover assets are segregated from the general assets of the issuer and used for repayment of the obligations under the covered bonds in priority to any other assets of the issuer (Covered Bond Act, Articles 15(1) and 45(1)).

III. COVER ASSETS

The cover assets can only be included in the cover pool of covered bonds to the extent that they satisfy the criteria set out in the Covered Bond Act and are free and clear of any lien or other encumbrance.

The cover pool of mortgage bonds may consist of receivables arising from (i) the loans secured by a mortgage on residential property located in the EEA or Switzerland, (ii) the loans secured by mortgage on commercial property located in the EEA or Switzerland (up to 20% of cover assets), (iii) the complementary cover assets (up to 20% of cover assets) and (iv) the derivative instruments (up to 12% of cover assets).

Cover pool of municipal bonds may consist of receivables arising from (i) the loan granted to, or debt securities issued by, an eligible state[3] or eligible local community[4], (ii) the loans granted to, or debt securities issued by, another legal entity provided that the obligations in respect to such loans or securities are guaranteed by an eligible state under an eligible guarantee, (iii) the complementary cover assets (up to 20% of cover assets) and (iv) the derivative instruments (up to 12% of cover assets).

The complementary cover assets may comprise of (i) cash on the account maintained at the Bank of Slovenia, (ii) marketable debt securities issued by an EEA member state and Switzerland (to the extent that its credit rating is equal to or higher than the Eurosystem's credit rating threshold) or its central bank or ECB, or other debt securities issued by EIB, EBRD or other bank according to criterion of ECB.

Issuer can also include the derivative instruments in the cover pool if they reduce risks associated with the cover assets, interest and/or currency mismatches applicable to cover assets and covered bonds.

There are certain other limits concerning the cover assets which comprise the cover pool (Covered Bond Act, Articles 25 and 38(4)):

- > Up to 5% of the cover pool may consist of mortgage loans secured by a mortgage on residential property under construction;

3 Eligible state is an EEA member state and Switzerland, to the extent that its credit rating is equal to or higher than the Eurosystem's credit rating threshold.

4 Eligible local community is a local community in EEA and Switzerland, to the extent that its credit rating is equal to or higher than the Eurosystem's credit rating threshold.

- Up to 10% of the cover pool may consist of mortgage loans secured by a mortgage the registration of which is still pending, provided that the process of registration is completed within 12 months from the date of filing of the application;
- Up to 20% of the cover pool may consist of mortgage loans to the same person or a group of legal entities which qualifies as a group of affiliated persons in accordance with the Banking Act, without prejudice to the rules on largest exposure applicable under the Banking Act.

IV. VALUATION AND LTV CRITERIA

The level of receivables from mortgage loans that can be taken into consideration for the cover assets must not exceed: (i) 80% of the mortgage lending value of the mortgaged property or, if the issuer decides to use the general market value, 50% of the general market value of property for loans secured by mortgage on residential properties; (ii) 60% of the mortgage lending value of the mortgaged property for loans secured by mortgage on commercial properties. When the level of receivables from mortgage loans exceeds the above restrictions, only an appropriate portion of the loan may be considered as cover assets (Covered Bond Act, Article 28).

The value of the residential and commercial properties can be estimated as the mortgage lending value[5] or market value[6]. Both, the mortgage lending value or market value, are determined by an independent property appraiser in compliance with the international property standards (Covered Bond Act, Article 26(4)). Residential properties can alternatively be estimated also by the use of a general market value appraised by the mass appraisal methods (Covered Bond Act, Article 27). The value of a property is determined individually for each real property (Covered Bond Act, Article 30(1)).

During the property mortgage loan term, the issuer must regularly monitor the value of the mortgaged property and re-assess this value at least once a year for commercial property and at least once every three years for residential property. Issuers may use statistical methods to monitor the value and identify the real property that requires revaluation. Further need for revaluation arises should the value of the real property and the general market prices of the real property in the area where the real property is situated have dropped by more than 20% in the period from the last valuation, or if a borrower is late in meeting his obligations for mortgage loans by more than 90 days (Covered Bond Act, Article 30(4)).

V. ASSET - LIABILITY MANAGEMENT

The issuer may issue mortgage or municipal bonds only to the extent that is necessary to ensure the coverage for liabilities from bonds in circulation and derivative instruments at all times by means of cover assets in at least the same nominal amount (Covered Bond Act, Article 22(1)).

Notwithstanding the provision regarding the nominal amount coverage, the matching of the cover assets with the liabilities from mortgage or municipal bonds and the derivative instruments is ensured at all times according to the present value principle; in this case, the cover assets' present value must exceed the present value of liabilities for mortgage or municipal bonds by at least 2% (Covered Bond Act, Article 22(2)).

The maturities, interest rates and currencies of the cover assets included in the cover register are adjusted to the maturities, interest rates and currency of the liabilities under the covered bonds and the derivative instruments (Covered Bond Act, Article 22(3)).

5 The mortgage lending value of real property shall be the value of real property as determined on the basis of prudential analysis of the possibilities of selling the property in the future carried out by an independent property appraiser by taking into consideration the long-term sustainability aspects of such property, the usual and the local market conditions, and its current and alternative proper uses without consideration of the speculative elements.

6 The market value of property is the price determined by an independent appraiser, at which the property could be sold by the seller to the buyer on the basis of a purely commercial relationship, without coercion.

The compliance with the conditions referred to in previous paragraphs must be verified at least once a month.

In addition, stress tests (test of the impact of the change in interest rates and foreign exchange rates) must be performed at least once a month. The issuer must initiate the procedure to increase the cover pool assets should the stressed present value of covered assets not exceed the stressed present value of liabilities of covered bonds by at least 2%.

The issuer must keep cover assets reserves by comparing the amount of matured receivables from cover assets entered in the cover register with the amount of matured liabilities from the issued mortgage or municipal bonds and the matured liabilities from the derivative instruments entered into, on a daily basis over the next 180-day period. Following the comparison of the largest calculated difference between the matured liabilities and the matured receivables, the issuer must provide coverage in the form of complementary assets (Covered Bond Act, Article 23).

VI. TRANSPARENCY

The Slovenian banking sector closely follows the developments regarding the ECBC's and its members' initiatives and trends on transparency. It should be noted that there have been no covered bond issuances from the Slovenian market yet; however the market initiative on the subject and, in particular, on the national transparency templates is currently being contemplated.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Obligation to keep a cover register

Issuer must keep a cover register and cannot transfer this task to other persons. The cover register includes the individual entries which represent cover assets for the issued mortgage or municipal bonds. The cover register also includes a record of all the mortgage or municipal bonds issued. The cover register reveals at all times the nominal value of cover assets and mortgage or municipal bonds in circulation (Covered Bond Act, Article 37). Only assets approved by the cover register administrator may be recorded in the cover register or struck off the cover register (Covered Bond Act, Article 38(3)).

When issuing mortgage and municipal bonds, the issuer must keep separate cover registers (Covered Bond Act, Article 51(2)).

Cover register administrator

Every issuer must have a cover register administrator[7] who is independent from the issuer and ensures that the cover register is maintained in accordance with Covered Bond Act, as well as the regulations issued on the basis thereof and performs the other tasks provided for by Covered Bond Act. The cover register administrator is appointed by the issuer (Covered Bond Act, Article 39).

The duties of the cover register administrator are: (i) to ensure that the cover assets provide coverage or the total value of the mortgage or municipal bonds in circulation and liabilities from the derivative instruments; (ii) to ensure the assets are registered in this register; (iii) prior to the issuance of mortgage or municipal bonds, the cover register administrator must confirm that the cover assets provide sufficient and adequate coverage for the bonds; (iv) to consider the issuer's requests for a cancellation of a mortgage as a security for the claims entered as coverage in the cover register; (v) to forthwith notify the Bank of Slovenia when the cover register administrator determines that the cover assets do not sufficiently cover the mortgage or municipal bonds and liabilities from the derivative instruments, or that they are otherwise contrary to the provisions

7 The cover register administrators shall be a person: (i) a certified public accountant who meets the requirements of the act governing auditing or persons with other professional qualifications; (ii) having previously obtained a licence from the Bank of Slovenia to perform the activities of cover register administrator; (iii) whose previous activity raises no doubt as to that person's suitability for the role of administrator (Covered Bond Act, Article 40).

of the Covered Bond Act; (vi) to regularly notify the Bank of Slovenia of its findings pursuant to the Covered Bond Act (Covered Bond Act, Article 41).

The responsibilities of the cover register administrator are: (i) to examine the books of account and other documents of the issuer that are in any way associated with the mortgage or municipal bonds and cover assets; (ii) to require from the issuer to keep the cover register administrator regularly informed of the performance of the cover asset-related repayments and any other changes associated with these assets (Covered Bond Act, Article 42).

Replacement of inadequate assets

The cover register administrator must require from the issuer to replace the inadequate mortgage loans if: (i) during the term of the mortgage loan, the value of real property declines to such an extent that the value of the outstanding mortgage loan exceeds the mortgage lending value or the real property's general market value level; or (ii) the borrower falls behind in meeting its payment obligations under the loan agreement for over 90 days; or (iii) the issuer receives the cover register administrator's written request related to the expiration of the time limit for entering the mortgage in the land register. In case of a decline in the real property value referred to in item (i), the issuer may supplement the existing receivables from mortgage loans by receivables from other mortgage loans or other suitable assets to the extent of the deficit in the cover assets resulting from a decline in the real property value (Covered Bond Act, Article 31).

Role of the Bank of Slovenia

The Bank of Slovenia supervises the implementation of the Covered Bond Act, grants authorisation to the bank prior to the issuance of the covered bond and grants license to the cover register administrator. In case of the issuer's insolvency, the Bank of Slovenia proposes to the court a cover assets trustee and is authorised to file a request to institute separate bankruptcy proceedings against the cover assets. The issuer and covered bond administrator have to regularly report to the Bank of Slovenia.

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

Segregation of cover assets

The cover assets that comprise the cover pool are evidenced by way of entry in the cover register; while they remain the property of the issuer, they are intended primarily for the payment of obligations under the covered bonds and the derivative instruments that are included in the cover pool (Covered Bond Act, Article 3(1)). Cover assets and complementary assets may not be used or pledged for any other purpose (Covered Bond Act, Articles 19(4) and 20(4)).

The issuer must ensure that the activities in connection with the covered bonds and cover assets are conducted separately from its other business activities (Covered Bond Act, Article 10).

Only the obligations of the issuer under the covered bonds and the derivative instruments can be enforced against the cover assets (Covered Bond Act, Article 37(5)). The law also sets limitations to the set-off rights of the debtors whose liabilities are included in the cover pool (Covered Bond Act, Article 37(6)).

Impact of the issuer's insolvency proceedings and the preferential treatment of the covered bond holders

Upon the issuer's insolvency, the cover pool is separated from the issuer's insolvency estate and the payment of obligations under the covered bonds and the derivative instruments, including the costs, from the cover assets is given priority over all other claims against the issuer (Covered Bond Act, Articles 45(1) and 44(1)). The consequences of the insolvency proceedings do not affect the issuer's obligations under the covered bonds and the derivative instruments (Covered Bond Act, Article 45(2)).

The court designates a cover assets trustee (who is not the same person as the issuer's insolvency administrator) entrusted with the management and disposal of cover assets to the extent necessary for the continuous payment of obligations under the covered bonds and the derivative instruments, for which no approval of the court is required (Covered Bond Act, Articles 46 and 47(1)). The court approval is required for the cover asset trustee's disposal of the cover pool and redemption of the covered bonds prior to their maturity, which is granted if such redemption increases the possibility of repayment of the issuer's obligations under the covered bonds and the derivative instruments (Covered Bond Act, Article 47(3)) – this is the only possible means of acceleration before the maturity of the covered bonds, they do not automatically accelerate in case of insolvency of the issuer nor can they be accelerated at the option of the holders (Covered Bond Act, Article 18).

The issuer's insolvency administrator may request the cover asset trustee to transfer to the issuer's insolvency estate such part of the cover assets that will, beyond any doubt, not be required for the payment of obligations under the covered bonds and the derivative instruments included in the cover pool; the decision on transfer vests with the court (Covered Bond Act, Articles 47(5) and (6)). Once all the obligations under the covered bonds and the derivative instruments have been paid, the cover asset trustee transfers the remaining cover assets to the issuer's insolvency estate (Covered Bond Act, Article 47(7)).

Should the cover assets prove insufficient to ensure the continuous payment of obligations under the covered bonds and the derivative instruments, a separate insolvency proceedings are initiated against the cover assets at the request of the Bank of Slovenia; the cover asset trustee can give the initiative to the Bank of Slovenia (Covered Bond Act, Articles 49(1) and (2)). If such separate insolvency proceedings still do not result in full payment of the obligations under the covered bonds and the derivative instruments, the holders of the covered bonds and the creditors under the derivative instruments are entitled to file a claim for the outstanding part of their receivables in the issuer's general insolvency proceedings (Covered Bond Act, Article 49(3)).

Access to liquidity in case of insolvency

The cover asset trustee is entitled to borrow money if this is required to ensure continuous compliance with the payment obligations under the covered bonds and the derivative instruments (Covered Bond Act, Article 47(2)).

Sale and transfer of cover assets to other issuers

Once appointed, the cover asset trustee may transfer the entire cover pool and all obligations arising under the issued covered bonds to a substitute issuer who is willing to assume such rights and liabilities, subject to the prior approval of the Bank of Slovenia (Covered Bond Act, Article 48).

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The risk weighting of covered bonds is regulated by two regulations adopted by the Bank of Slovenia, (Regulation on the calculation of capital requirements for credit risk under the standardised approach for banks and savings banks and the Regulation on the calculation of capital requirements for credit risk under the internal ratings based approach for banks and savings banks, both published in the Official Gazette of the Republic of Slovenia, No. 135/06, as amended). The banks using the standardised approach assign the risk weightings to their covered bond exposures based on the risk weighting of the issuer (e.g. covered bonds of the credit institution with a 20% risk weighting are assigned a 10% risk weighting). Under the internal ratings based approach the loss given default (LGD) for covered bonds is set at 11.25%.

The provisions of the Covered Bond Act fall within the criteria of the Annex VI, Part 1, Paragraph 68 (a) to (f) of the Capital Requirements Directive as well as the criteria of the Article 52(4) of UCITS directive.

3.31 SOUTH KOREA

By Hoin Lee, Kim & Chang and Frank Will, RBS

I. FRAMEWORK

Past Efforts to Create a Covered Bond Market in Korea

Currently, Korea does not have legislation for covered bonds. Domestic banks in Korea had been looking at covered bonds as an alternative source of funding and the Korea Federation of Banks, a major association of banks in Korea, set up a task force team in 2008 to pursue the introduction of covered bonds in Korea, including by way of a dedicated covered bond statute. Even prior to the Korea Federation of Banks task force team, market participants were looking into alternative structured covered bond structures utilizing Korea's Act on Asset-Backed Securitization (the "ABS Act").

Such efforts eventually led to Kookmin Bank's offshore covered bond issuance in May 2009 (the "KB Covered Bonds"). Kookmin Bank developed a structure on the basis of the securitization techniques under the ABS Act and the Trust Act that enabled the relevant asset pool to be "ring fenced" and effectively granted dual-recourse to its investors through contractual arrangements. The KB Covered Bonds were the first covered bonds out of Korea and the Asia-Pacific region.

Many Korean banks looked into possible issuance of similar structured covered bonds after the KB' inaugural transaction. Due to the complex structure and favorable market conditions allowing banks to procure funding at acceptable rates, Korean banks did not follow through with covered bond issuance under the Kookmin Bank structured covered bond model.

Separately, in July 2010, the Korea Housing Finance Corporation ("KHFC") issued the second covered bond out of Korea and the first statutory covered bond transaction out of Asia. KHFC utilized the "mortgaged-backed bonds" (the "KHFC Covered Bonds") under the Korea Housing Corporation Act (the "KHFC Act") in issuing the covered bonds. The KHFC Act contemplates various financing options for KHFC and to issue mortgage-backed bonds is one of these options. Mortgaged-backed bonds are economically similar to covered bonds because the bond holders have a statutory priority right over a pool of assets segregated from the other assets of KHFC.

The successful issuance of the KHFC Covered Bonds in 2010 stimulated new interest for covered bonds in Korea, with KHFC Covered Bonds being considered as a potential alternative to traditional residential mortgage backed securities (RMBS) transactions as a funding source for Korean mortgage lenders. Several follow-on transactions have been completed that utilize KHFC as the issuer and the dual recourse feature of mortgage-backed bonds under the KHFC Act.

Despite these past attempts to create a covered bond market in Korea, the KB Covered Bonds and the KHFC Covered Bonds have not yet been able to promote the development of a robust Korean covered bond market possibly due to the lack of a dedicated covered bond legal framework.

Covered Bond Best Practice Guidelines

As follow-up to the 'Comprehensive Measures to Address Household Debt' that was announced on June 29, 2011, the Financial Services Commission (the "FSC") and the Financial Supervisory Service (the "FSS") announced the best practice guidelines regarding the issuance of covered bonds (the "Best Practice Guidelines") that became effective on June 30, 2011. The Best Practice Guidelines stop short of a dedicated covered bond legislation. Nonetheless, it was intended to provide a framework for covered bond issuances in Korea by providing relatively specific details regarding the definition of covered bonds, issuer requirements, cover asset eligibility, asset maintenance and disclosure requirements.

To be consistent with the Best Practice Guidelines, a covered bond program must meet the following criteria.

Issuer Requirements: Covered bonds may be issued by (1) a bank established under the Bank Act, (2) NH Bank under the Agricultural Cooperatives Act, (3) the credit business sector of the National Federation of Fisheries Cooperatives, (4) Korea Development Bank, (5) Export-Import Bank of Korea, (6) Industrial Bank of Korea, and (7) a securitization vehicle organized pursuant to the ABS Act by any such financial institution. However, the BIS ratio of the financial institution must have been 10% or greater as of the end of the fiscal year immediately preceding the issuance.

Requirements for the Issuance of Covered Bonds: Covered bonds may be issued with maturities ranging from 1 year up to 30 years, either in KRW or a foreign currency, and can have either fixed or floating interest rates. However, an issuer cannot issue covered bonds in excess of 4% of its total liabilities as of the end of the fiscal year immediately preceding the issuance.

Cover Asset Eligibility: The cover pool may be comprised of (1) first priority mortgage loans with maximum secured amount being 120% or more of the actual loan amount, a 70% cap on loan-to-value (LTV) ratio and no delinquencies in excess of 60 days, (2) cash, (3) ABS backed by such mortgage loans or cash, (4) KHFC Covered Bonds issued by KHFC, and (5) mortgage-backed securities issued by KHFC.

Maintenance of Cover Assets: Overcollateralisation is required to be at least 5% of the aggregate amount of covered bonds outstanding and assets in the cover pool that no longer satisfy the eligibility criteria may be replaced with eligible assets. Moreover, an issuer must appoint a covered bond administrator to manage the cover assets. An asset monitor must also be appointed to evaluate the eligibility of cover assets as of month-end or quarter-end and provide investors with results of the evaluations.

Disclosure Requirements: The issuer is required to submit an issuance plan to the FSS. This plan should cover market conditions, the financing measures typically employed by the issuer, the usage for the proceeds of the issuance of the covered bonds, the issuance volume and date and the cost-benefit analysis of the issuance, etc. Following the issuance, the issuer is obligated to disclose the aggregate outstanding amount of the covered bonds and the face value (or fair value) of the cover pool on a quarterly basis. This information should also be included in its annual financial statement.

Proposed Act on Issuance of Covered Bonds

The Best Practice Guidelines have not sparked the growth of a Korean covered bond market. Industry players have been advocating for a dedicated covered bond legislation in Korea to establish covered bonds as an important funding source for Korean financial institutions, in particular, because the dual recourse nature of covered bonds provides lower credit risk and lowers the funding cost to issuers. Responding to such expectation of industry players, on October 24, 2012, the FSC issued a legislative notice regarding the proposed Act on Issuance of Covered Bonds (the "Proposed Act"), the purpose of which is to contribute to (i) stable long term financing means of banks and (ii) improvement of household debt structure. On January 29, 2013, the Government Cabinet Meeting approved the Proposed Act and submitted the bill to the National Assembly on February 5, 2013. As of the end of July 2013, the Proposed Act is awaiting approval from the National Assembly.

The dual recourse features in the KHFC Covered Bonds provide a statutory priority right of payment for investors over the cover pool. Following the successful offshore issuance of the KHFC Covered Bonds in 2010, as of the end of July 2013, KHFC has closed eight more covered bond transactions, six of which were domestic issuances. This article focuses on KHFC's covered bond program and the Proposed Act.

II. STRUCTURE OF THE ISSUER

(1) KHFC ACT

Eligible Issuer

KHFC, which is wholly owned by the Korean government and the Bank of Korea, is the only eligible issuer of KHFC Covered Bonds. Pursuant to Article 31 of the KHFC Act, the holders of KHFC Covered Bonds have a statutory priority right of payment from a separately managed pool of mortgage loans designated as the underlying collateral for KHFC Covered Bonds (the "KHFC Cover Pool"). In addition, if principal and interest on a KHFC Covered Bond are not fully paid out of the KHFC Cover Pool, it can be paid from the general assets of KHFC. KHFC issues these bonds without transferring the cover assets to a separate legal entity and the bankruptcy remote cover assets are left on KHFC's balance sheet.

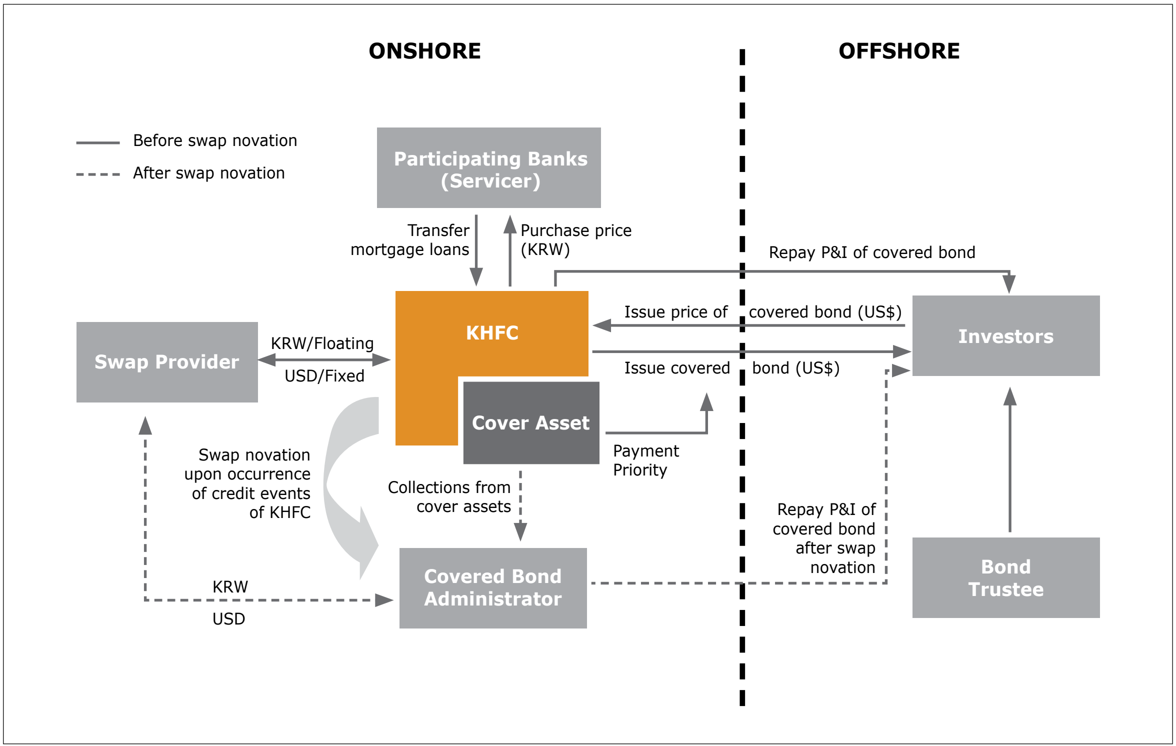
A bond trustee is typically appointed to act on behalf of the investors and an onshore covered bond administrator is appointed for the purpose of the automatic swap novation described below. The investors have dual recourse in respect of the KHFC Covered Bonds: (a) a senior unsecured claim to KHFC upon the occurrence of an issuer event of default or at maturity; and (b) a statutory priority right of payment over the KHFC Cover Pool.

In the case of KHFC Covered Bonds issued offshore, KHFC enters into a cross currency swap agreement and an interest rate swap agreement with the swap providers, pursuant to which KHFC will deliver KRW interest periodically and principal at maturity to the swap providers in exchange for U.S. dollar currency payments. The swap providers pay U.S. dollar interest periodically and principal at maturity. The swap agreement is subject to an automatic swap novation mechanism (the "Swap Novation") in which the swap providers, KHFC, and the covered bond administrator entered into a tripartite automatic novation agreement, which states that the swap agreement will be automatically terminated with KHFC and novated to the covered bond administrator upon the occurrence of certain events of default regarding KHFC, and that the mark-to-market valuation of the swap agreement as of the novation date will not be exchanged between KHFC and the swap providers or between KHFC and the covered bond administrator.

Subsequent to such events of default, the covered bond administrator will pay KRW generated from the KHFC Cover Pool to the swap providers in exchange for the U.S. dollar denominated payments, and the swap providers will pay the U.S. dollar denominated interest periodically and principal at maturity.

The following diagram illustrates the structure of the KHFC Covered Bonds transaction.

Figure 1: KHFC Covered Bonds Transaction Structure



Source: Kim & Chang

Issuance Limit

KHFC may issue KHFC Covered Bonds up to 50 times of its paid-in equity capital.

(2) PROPOSED ACT

Eligible Issuer

Eligible issuers of covered bonds under the Proposed Act (the "Covered Bonds") include (i) banks licensed and established under Bank Act of Korea, (ii) the Korea Development Bank under the Korea Development Bank Act, (iii) the Export-Import Bank of Korea under the Export-Import Bank of Korea Act, (iv) the Industrial Bank of Korea under the Industrial Bank of Korea Act, (v) NH Bank under the Agricultural Cooperatives Act, (vi) the credit business division of National Federation of Fisheries Cooperatives under the Fisheries Cooperatives Act, (vii) KHFC under the KHFC Act, (viii) the Korea Finance Corporation under the Korea Finance Corporation Act, or (ix) any other company engaging in finance business pursuant to other laws as prescribed by the Presidential Decree of the Proposed Act (the "Presidential Decree"). The Presidential Decree draft has not been made public yet. Eligible issuers of Covered Bonds, however, must have equity capital of not less than KRW 100 billion, Bank for International Settlements (BIS) ratio of not less than 10%, and appropriate funding and operation structures and risk management procedures, etc.

Issuance Limit

Eligible Issuers may issue Covered Bonds up to the ceiling set by the Presidential Decree which shall not exceed 8% of its total assets as of the end of the fiscal year immediately preceding the scheduled date of issuance.

III. COVER ASSETS

(1) KHFC ACT

The mortgage loans in KHFC's cover pool are acquired from certain Korean financial institutions that function as the originating banks. The individual mortgage loans included in the cover pool may change from time to time as a result of substitutions by KHFC, and KHFC is responsible for ensuring that the mortgage loans are properly serviced and will delegate its servicing responsibility to the originating banks, with each originating bank servicing those mortgage loans originated and sold by it to KHFC.

(2) PROPOSED ACT

The cover pool shall comprise of (1) the Underlying Assets, (2) the Liquid Assets and (3) Other Assets. The "Underlying Assets" shall include (i) residential mortgage loans with 70% or lower loan-to-value (LTV) ratio, obligors of which are not subject to insolvency proceedings, (ii) loan receivables against the government, a local government or a corporation incorporated under the special laws, (iii) Korean Treasury bonds, municipal bonds or bonds issued by a corporation incorporated under the special laws, (iv) mortgage loans secured by ships or aircraft and any other assets of good quality to generate steady cash flow as prescribed by the Presidential Decree. The "Liquid Assets" shall comprise of cash or certificates of deposit with a maturity of no more than 100 days issued by financial companies other than the issuer of the Covered Bonds while "Other Assets" shall comprise of collections and other property rights acquired from the Underlying Assets and the Liquid Assets and the claims acquired from derivatives transactions executed in order to hedge foreign exchange rate or interest rate risks and other risks associated with the cover pool pursuant to the Covered Bond issuance plan.

IV. VALUATION AND LTV CRITERIA

(1) KHFC ACT

KHFC's detailed rules for the purchase of residential mortgage loans stipulates the requirements of such loans that it can acquire from financial institutions, prescribing that if debt-to-income (DTI) ratio is in excess of 44% but no higher than 100%, LTV shall not exceed 60%, while if DTI ratio is 44% or lower, LTV shall be 70% or lower for apartments or 65% or lower for general houses. However, if (i) the grace period is in excess of 1 year; (ii) the interest rate is floating rate; (iii) the credit rating is at or below a certain grade; or (iv) in case of newly constructed apartments whose collateral valuation is based on their initial sale price, LTV shall be 60% or lower.

There is no statutory standard for valuation of residential mortgage loans that are included in KHFC's cover pool. Instead, the valuation methods are set forth in individual transaction documents for the KHFC Covered Bonds which value residential mortgage loans between 100% to 0% depending on the length of delinquency.

(2) PROPOSED ACT

Article 5 of the Proposed Act requires that LTVs for residential mortgage loans in the cover pool shall be 70% or lower, whereas the LTVs of loans secured by ships or aircrafts are to be prescribed by the Presidential Decree. In addition, the valuation standard and method, etc. for each type of cover assets has been delegated to the Presidential Decree.

V. HEDGING AND ASSET – LIABILITY MANAGEMENT

(1) KHFC ACT

In the case of KHFC Covered Bonds issued offshore, the underlying residential mortgage loans are denominated in KRW but the KHFC Covered Bonds are issued in foreign currency and KHFC entered into swap agreements to hedge the resulting currency risk. This swap agreement is subject to the Swap Novation described above.

There are no statutory regulations on overcollateralisation or excess yield of collateralized assets. However, the transaction documents in previous KHFC Covered Bonds have required the Cover Pool to satisfy an asset coverage test and portfolio yield test and the failure for the KHFC Cover Pool to satisfy the foregoing tests for a certain period of time becomes an issuer event of default which in turn triggers the management of the cover pool to be transferred to a separately appointed covered bond administrator, in addition to the above-mentioned Swap Novation.

(2) PROPOSED ACT

The total value of the Cover Pool shall be equal to or more than 105% (the "Required Overcollateralisation Ratio") of the total value of the Covered Bonds and the liquid assets shall not exceed 10% of the total value of the Cover Pool. The details of the valuation standard and method, etc. for each type of assets comprising the Cover Pool shall be prescribed by the Presidential Decree. The Issuer shall prepare and maintain separate books for the management of the Cover Pool. If the total value of the Cover Pool is likely to fall below the Required Overcollateralisation Ratio or cover assets fail to satisfy the Cover Pool eligibility criteria set forth in the Proposed Act (the "Cover Asset Eligibility"), the issuer shall add or substitute the Underlying Assets and Liquid Assets without delay in order to comply with the Required Overcollateralisation Ratio and the Cover Asset Eligibility. In this case, the relevant assets shall be deemed to form part of the cover pool until the relevant assets are substituted.

Unlike the KHFC Act, the claims acquired from derivatives transactions executed in order to hedge foreign exchange rate or interest rate risks and other risks associated with the Cover Pool pursuant to the covered bond issuance plan are included in the cover pool as described above and the swap provider also has a priority right of payment from the cover pool under the Proposed Act. As such, we do not expect there to be a particular need to novate the relevant swap agreement to a third party.

VI. TRANSPARENCY

(1) KHFC

To issue KHFC Covered Bonds, KHFC must register a securitization plan with the FSC and this securitization plan is available to the public on the FSS website. Amendments to the securitization plan after issuance must also be registered with the FSC.

The securitization plan should include (i) name of KHFC and location of its office, (ii) term of the securitization plan, (iii) the details, total sum and appraisal value of the residential mortgage loans as cover assets, (iv) types, total sum and issuance conditions of the KHFC Covered Bonds to be issued, (v) matters concerning management, operation and disposition of the residential mortgage loans as cover assets, and (vi) matters concerning the covered bond administrator.

(2) PROPOSED ACT

Any eligible issuer that intends to issue Covered Bonds must register the Covered Bond issuance plan and details of the cover pool with the FSC. The issuer must also register amendments to the issuance plan or the matters concerning the cover pool, while minor changes shall be reported to the FSC within seven days from the date of such change. The issuance plan should include (i) the terms and conditions of the Covered Bonds, (ii) qualification requirements of the issuer pursuant to the Proposed Act such as equity capital, balance sheet, etc., (iii) the details of the cover pool, (iv) total valuation amount and details of such valuation of the cover pool, (v) the Required Overcollateralisation Ratio, (vi) details of the cover pool monitor and (vii) other information as prescribed by the Presidential Decree.

The issuer is required to establish and monitor at least on a quarterly basis separate risk management standards and procedures relating to the issuance and redemption of the Covered Bonds. The issuer is also obligated to disclose on its website on a quarterly basis the result of risk management monitoring, the report prepared by the cover pool monitor and other information necessary. The FSC may request data concerning business or properties of the issuer and its administrator and the cover pool monitor, or investigate such business and properties if necessary for protecting the Covered Bond investors.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

(1) KHFC ACT

There are no explicit provisions in the KHFC Act on the cover pool monitor but independent third parties are appointed to supervise and monitor KHFC's management of the KHFC Cover Pool. For example, an accounting firm has been appointed as the cover pool monitor in previous KHFC Covered Bond issuances to be responsible for confirming whether the KHFC Cover Pool minimum maintenance requirements have been satisfied. In addition, the covered bond administrator is appointed in advance for the management of the cover pool in order to protect the KHFC Covered Bond holders upon occurrence of any issuer event of default including a bankruptcy event of KHFC.

(2) PROPOSED ACT

The Issuer shall appoint with the approval from the FSC a cover pool monitor to monitor the eligibility of the cover pool independently. The cover pool monitor shall be (i) a person who qualifies as a bond administrator under the Korean Commercial Code, (ii) KHFC (excluding the case where the issuer is KHFC) or (iii) a corporation with five or more administration personnel including such experts as lawyers, certified public accountants or certified public appraisers necessary for the performance of duties as a cover pool monitor with equity capital of KRW 1 billion or more.

The cover pool monitor is authorized to take any actions in court or otherwise necessary for the management, maintenance and disposition of the Cover Pool. The cover pool monitor is obligated to submit on a quarterly basis a report to the FSC on the performance of its duty as a cover pool monitor and provide it to the issuer and, upon request, the covered bond investors and other parties, as described below, who have a priority right of payment from the registered cover pool.

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

(1) KHFC ACT

Articles 30 and 31 of the KHFC Act state that (i) KHFC may issue the KHFC Covered Bonds with a statutory priority right of payment over the mortgage loans separately managed in accordance with the applicable KHFC Act securitization plan, and (ii) if mortgage loans in the KHFC Cover Pool are separately managed according to the applicable KHFC Act securitization plan, the investors will have a priority right of payment against such mortgage loans unless otherwise prescribed in other laws. Considering the legislative intent and history of these provisions, the statutory priority right of payment over the mortgage loans owned by KHFC was considered as having been granted to the investors through the registration with the FSC of the applicable KHFC Act securitization plan without taking any other actions necessary for the establishment or perfection of the statutory priority right.

KHFC is required to separately manage the mortgage loans included in the cover pool from its other assets on the basis of the applicable KHFC Act securitization plan.

(2) PROPOSED ACT

Article 13 of the Proposed Act states that (i) holders of Covered Bonds, (ii) swap providers, (iii) claimholders relating to the redemption/maintenance and management of the Covered Bonds and management/disposal and execution of the cover pool, and (iv) the cover pool monitor have a priority right of payment on the registered Cover Pool over third parties. Article 12 of the Proposed Act states that, in case of an issuer's insolvency, the cover pool shall not be subject to the issuer's insolvency proceedings, including compulsory execution, preservative measures and stay orders. If the principal of the covered bonds is not fully repaid, covered bond holders have the right to payment from other assets of the issuer in addition to the cover pool. With the consent of the holders of at least 75% of the aggregate outstanding principal amount of the covered bonds, FSC may issue an order to transfer relevant contracts to another eligible issuer.

The issuer is required to separately manage the mortgage loans included in a cover pool from its other assets on the basis of the applicable issuance plan. The books for the cover pool must also be separately maintained and any violation may be subjected to criminal sanctions.

IX. RISK-WEIGHTING AND COMPLIANCE WITH EUROPEAN REGULATION

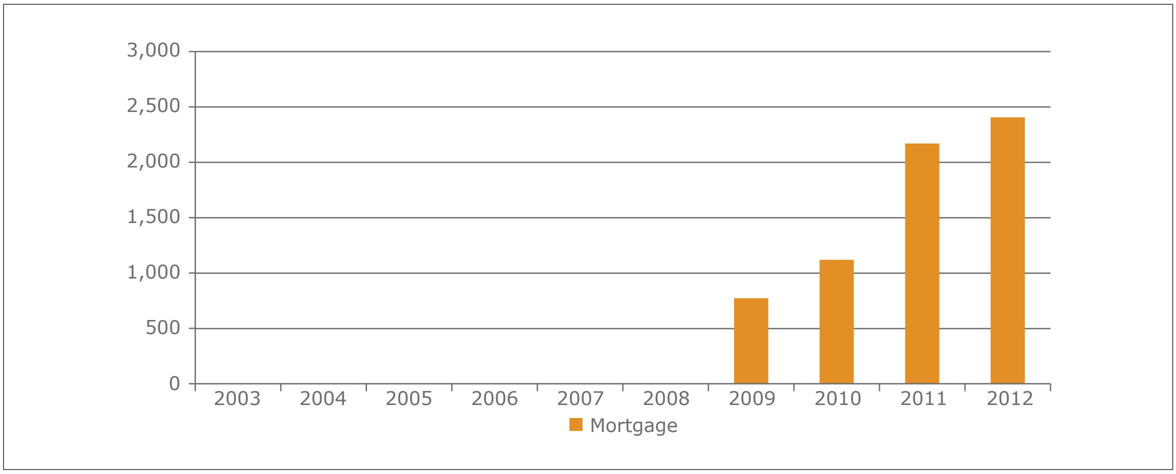
The Covered Bonds under the Proposed Act and the KHFC Covered Bonds under the KHFC Act are not compliant with UCITS 52(4), in which case they may not benefit from the higher investment limits because neither KHFC nor any of the potential issuers of the Covered Bonds is a credit institution with its registered office in a EU member state. These covered bonds cannot be CRD compliant without meeting UCTIS 52(4). Thus, the covered bonds cannot benefit from special treatment in terms of risk weighting.

X. ADDITIONAL INFORMATION

There have been 10 covered bond issuances by Korean issuers, four of which were foreign currency denominated covered bonds issued offshore. Apart from the Kookmin Bank structured covered bond, all the others were KHFC Covered Bond issuances.

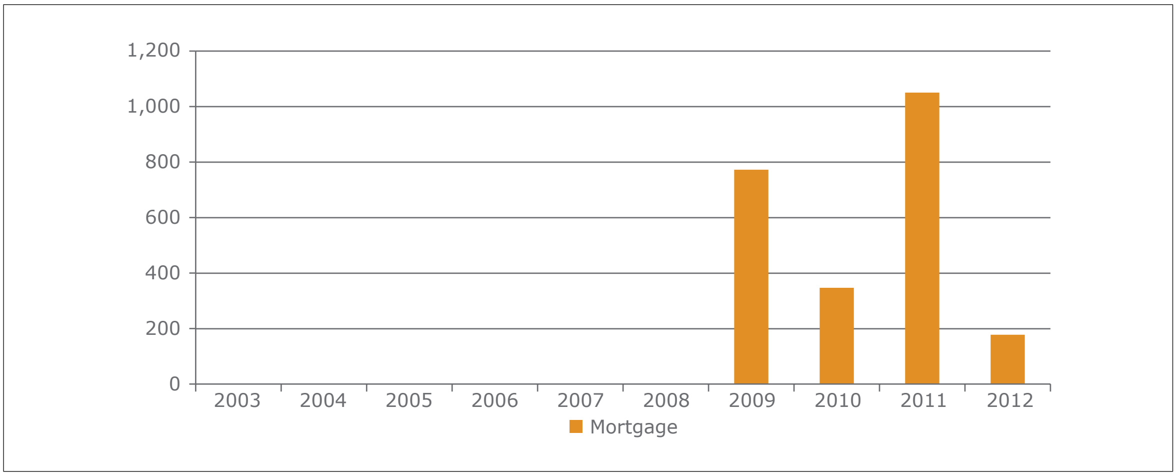
Issuer	Issue Date	Face Amount	Credit Rating	Market
Kookmin Bank	May 14, 2009	US$ 1 billion	AA/Aa2 (S&P/Moody's)	Offshore
KHFC	July 15, 2010	US$ 500 million	Aa3 (Moody's)	Offshore
	April 28, 2011	US$ 200 million	AAA (NICE/KIS)	Onshore
	June 17, 2011	KRW 250 billion	AAA (KR)	Onshore
	July 25, 2011	US$ 500 million	Aa3 (Moody's)	Offshore
	December 8, 2011	KRW 290 billion	AAA (KR)	Onshore
	December 29, 2011	KRW 250 billion	AAA (KR)	Onshore
	March 30, 2012	KRW 250 billion	AAA (KIS)	Onshore
	March 7, 2013	US$ 500 million	Aa1 (Moody's)	Offshore
	March 7, 2013	KRW 150 billion	AAA (KIS)	Onshore

> Figure 2: Covered Bonds Outstanding, 2003-2012, EUR m



Source: EMF/ECBC

> Figure 3: Covered Bonds Issuance, 2003-2012, EUR m



Source: EMF/ECBC

3.32 SPAIN

By Gregorio Arranz, Spanish Mortgage Association

I. FRAMEWORK

The legal framework for Spanish covered bonds –"Cédulas Hipotecarias" (CHs) – is determined by the Law 2/1981, of 25 March, on the regulation of the mortgage market (hereinafter, "Law 2/1981"), Law 41/2007, of 7 December, by which Law 2/1981, of 25 March, regulating the mortgage market and other rules of the mortgage and financial system are modified, reverse mortgages and long-term care insurance are regulated and certain tax regulations are established (hereinafter Law "41/2007") and the Royal Decree 716/2009, of 24 April, which develops certain aspects of Act 2/1981 and other rules of the mortgage and financial system (hereinafter "RD 716/2009"). In May 2013, a new Law (Law 1/2013 of 14 May) on protection of mortgage debtors, restructuring of mortgage debt and rented social housing has been approved and will partially affect mortgage and procedural laws and some very specific points of Law 2/81 referred below.

Regarding bankruptcy regulation, article 14 of Law 2/1981 (modified by the 19th final provision of Law 22/2003, of 9 July hereinafter, the "Insolvency Law" and by Law 41/2007 provides for a special treatment for the holders of the CHs in case of insolvency of the issuer. According to this article, CH holders have special privileged claims (*créditos con privilegio especial*) as established in article 90 of the Insolvency Law.

Article 12 of Law 2/1981 defines that the capital and interests of the CH are secured by the entire mortgage loan book registered in favour of the CH issuer (excl. loans used in securitisations or loans securing mortgage bonds).

Moreover, article 14 of Law 2/1981 determines that in case of issuer insolvency claims of CH holders shall be treated as privileged claims against the insolvency estate (*créditos contra la masa*). It shall be considered as credits against the mass: all the payments which correspond to the repayment of the capital and interest of the issued cédulas hipotecarias and, if any, to the substitution assets which backup the cédulas hipotecarias and the economic flows generated by the financial instruments linked to the issues. (art. 14 Law 2/1981) Pursuant to article 84.2.7, in combination with article 154, of the Insolvency Law, claims against the insolvency estate have to be paid on their respective due dates without delay of payment, regardless of the status of the bankruptcy proceedings.

In addition, the second additional provision of the Insolvency Law, modified by Royal Decree – Law 3/2009, of 27 March, establishes that in case of insolvency of credit institutions their specific legislation, specifically articles 10, 14 y 15 of Law 2/1981 of mortgage market, shall be applicable. As a result, the mortgage market law supersedes the Insolvency Law.

II. STRUCTURE OF THE ISSUER

Issuers of CHs have to be credit institutions, entitled to participate in the mortgage market and thus, to grant the mortgage credits or loans that comply with the requirements of the Spanish Mortgage Market Legislation. In practice, issuers of CH are mainly: Commercial Banks, Saving Banks, and Cooperative Banks.

The issuer of the CHs holds the cover assets on his balance sheet and they are not transferred to a different legal entity.

The CHs, in addition to being direct, unconditional obligations of the issuer and without prejudice to the unlimited universal nature of the liability, comprise a special privileged credit right of its holder against the issuer, and if any, against the substitution assets which backup the cédulas hipotecarias and the economic flows generated by the financial instruments linked to each issue. This right is guaranteed by the entire mortgage loan book registered in favour of the issuer. The effectiveness of this right is also guaranteed by the existence of mandatory over-collateralisation.

Although there is no direct link between the covered bonds and the underlying mortgaged properties, there is a direct link between CHs and the cover assets.

Due to the status of the issuer as a credit institution, one of the requirements to conduct business is to have adequate human and material resources pursuant to the credit institution legislation.

The degree of outsourcing covered bond issuance activities is quite low, almost irrelevant. Usually, the outsourced service has to be provided by a well-known servicer with an adequate rating. In any case the issuer is responsible and liable for the performance of the service.

Additionally, several entities can group their CHs issuances in a CDO structure (called multi-seller structure). This is based on the issuance of securitisation bonds, backed by the cash-flow generated by such CHs, by an open vehicle that, under Spanish law, is created as a separate fund without legal personality, serviced by a securitisation fund trustee or management company. The bondholders of each of the series issued by the fund will bear the risk of default on the CHs backing the bonds. The holders of these securities, known as "cédulas multicedentes" enjoy all of the advantages of the covered bond but as well of a higher degree of risk diversification. .

It is important to point out that there is another Spanish covered bond called Cédulas Territoriales (CTs) with the same special privilege claim status as CHs. In this case, the cover asset pool consists of all loans to the Spanish State, its autonomous communities and local authorities, as well as their entities and dependent public companies and entities of a similar nature in the European Economic Area. The credit institutions may issue CTs up to 70% of the eligible public loan portfolio, resulting in a minimum over-collateralisation of 43%. Later on, the Royal Decree –Law 20/2012, of 13 July, which focuses on measures to guarantee budget stability and to promote competition has created the so called "Cédulas de Internacionalización" which are covered bonds very similar to cédulas hipotecarias where the cover asset pool consists of loans and credits associated with the financing of export agreements. For the time being no issuance has taken place. The total amount cannot exceed70% of the eligible amounts. Last but not least, a last type of covered bonds is the Bonos Hipotecarios that, although contemplated in Law 2/1981, have not been used for the time being. These bonds have specific mortgages as collateral and not the whole portfolio.

III. COVER ASSETS

A distinction shall be made between cover assets and eligible assets.

Cover assets consists of the entire mortgage loan book registered in favour of the issuer. The special privileged claims of the holders of CHs are guaranteed by the cover asset pool and if any, by the substitution assets which backup the cédulas hipotecarias and the economic flows generated by the financial instruments linked to each issue.

The Law 2/1981 does not establish specific requirements for mortgage loans that constitute the cover asset pool.

For issuance purposes and their limits, it shall be considered as eligible assets in order to determine the maximum amount of CH issued and outstanding for a particular issuer.

All mortgage loans which comply with the following criteria are taken into account for the calculation of the maximum amount of CH issued and outstanding:

> The object of the loan or credit must be the financing of the construction, reconstruction, or acquisition of residential premises, zoning works and social equipment, construction of agrarian buildings, tourist, industrial and commercial and any other activity or work and any other loan, regardless its purpose.

> The mortgage that guarantees the loan or credit must be a first-ranked mortgage.

> The loan or credit guaranteed may not exceed 60% (art. 5 Law 2/1981 modified by Law 41/2007) of the mortgage lending value of the mortgaged asset, except for the financing of the construction, reconstruction or acquisition of residential premises, in which case it may reach 80% of such value.

> The 80% limit in the ratio between the guaranteed loan or credit and the value of the mortgaged home mentioned in the previous section can be exceeded, without under any circumstances exceeding 95%, if the mortgage loan or credit has a bank guarantee provided by a different credit institution to the creditor or is covered by credit insurance. The bank guarantee or insurance shall be direct and will cover at least the amount of the guaranteed loan or credit which exceeds 80% of the valuation of the mortgaged asset and interests (Art. art. 5 RD 716/2009)

  Notwithstanding, mortgaged loans or credits that initially exceed these percentages can be used as cover assets for the issuance of CHs when, as a consequence of the repayment of their principal amount or the modification of the market value of the mortgaged properties the values do not exceed said LTV, in relation to the initial or revised valuation of the mortgaged asset.

  The mortgaged properties must have been valued previously by the so-called "Sociedades de Tasación" or by the valuation services of the issuer.

> The mortgaged assets must be insured against damages.

> Residential mortgage loan cannot exceed 30 years.

  All mortgage loans that do not fulfil at least one of the above mentioned criteria cannot be taken into account for the calculation of the maximum amount of CH.

Excluded from cover asset pool are special types of mortgage credits or loans, such as:

> Those documented by way of registered securities, either to the order or bearer securities.

> Those which are partially or totally due.

> Those which have already been the subject of mortgage participations ("Participaciones Hipotecarias", i.e. loans used in securitisations).

> Those subject to senior mortgages or seizure.

The right to use and enjoy ("derecho de usufructo") administrative concessions, rights to extended areas ("derechos de superficie") and real estate properties which do not have building codes (i.e. those which are outside the zoning regime) are excluded as well.

The cover asset pool is defined as a dynamic cover pool. ABS/MBS or other assets are not allowed in the cover pool, but mortgages are allowed.

It is market practice for the issuer to hedge the interest rate risk by using the corresponding derivative instrument.

The institution issuing the cédulas hipotecarias will keep a special accounting register of the loans and credits that serve as collateral of the issues of cédulas hipotecarias and, if any, of the substitute assets fixed that cover them, as well as the derivative financial instruments linked to each issue. The annual accounts of the issuing institution shall contain the essential details of said register (art. 12 Law 2/1981, art. 21 RD 716/2009 and Circular 7/2010 of 30 November of the Bank of Spain).

In order to guarantee the transparency of the cover assets, the issuers have to provide the Bank of Spain with a monthly cover pool report. Moreover, there is a general duty of disclosure as a result of the continuous supervisory power of the Bank of Spain.

IV. VALUATION AND LTV CRITERIA

According to mortgage market legislation, the value of the mortgaged property has to be appraised prior to the issuance of the CHs by specialised companies, the so-called *Sociedades de Tasación or by the valuation services of the issuers*.

As said before, for eligible assets, the loan or credit guaranteed may not exceed 60% (art. 5 Law 2/1981 modified by Law 41/2007) of the mortgage lending value of the mortgaged asset, except for the financing of the construction, reconstruction or acquisition of residential premises, in which case it may reach 80% of such value.

The mortgage markets legislation also determines the regulation for the appraisal service and the requirements with which the specialised companies have to comply, such as, an exclusive corporate object, minimum corporate capital requirement, registration with the corresponding registry at the Bank of Spain. The last legal reform as of May 2013 prevents credit institutions from owning more than a 10% of appraisal companies' capital. Moreover, those entities are supervised and subject to inspection by the Bank of Spain. These rules were developed by the Ministerial Order of 27 March of 2003 in relation to the appraisal of real estate goods.

V. ASSET - LIABILITY MANAGEMENT

The volume of CHs issued and outstanding by a particular Issuer cannot exceed 80% (art. 16 Law 2/81) of the sum of the unpaid principal amounts corresponding to all the mortgage credits or loans included in the Issuer's portfolio that comply with the requirements mentioned above under section III on cover assets. The issuer cannot issue CHs beyond these percentages at any time.

The cédulas hipotecarias can be backed up to a limit of 5% of the issued capital by substitution assets (fixed income securities issued by the State and other EU Member States, cédulas hipotecarias, mortgage bonds, securities issued by Mortgage Securitisation Funds or Asset Securitisation Funds and other fixed-income securities listed on an official secondary market or on a regulated market, with a credit rating equivalent to that of the Kingdom of Spain –art. 15 and 17 Law 2/1981)

Notwithstanding this general statement, if the limit is surpassed due to increases in the redemption of the Elegible Assets or any other event whatsoever, the Issuer shall re-establish due balance by means of any of the following actions:

- Cash deposit or deposit of government paper in the Central Bank of Spain.
- Acquisition of CHs in the relevant marketplace.
- Execution of new mortgage loans or acquisition of mortgage participations, provided that they are eligible to cover CHs.
- Redemption of CHs by the pertinent amount until balance has been reinstated, which, if necessary, can be executed through early redemption and drawing the number of securities to be redeemed by lot.

As a general remark it should be noted that it is market practice for the issuer to hedge interest rate risk.

Moreover, regulation provides for some particular rules in this respect that can be summarised as follows: Issuers shall adopt the necessary measures to avoid inappropriate imbalances between the flows from the cover portfolio and those derived from the payments due for the cédulas that they issue (article 17.6 of RD 716/2009).

Concerning foreign exchange risks, there is no legal provision in relation to the following areas

- The currency of the covered bonds
- Limiting FX risks between cover assets and the CHs
- Limiting, managing or hedging the exchange risk as in the case of the interest rate risk. Notwithstanding, it is universal market practice to denominate the CHs in Euro if the currency of the cover assets is Euro.

Other risks such as early repayment, reinvestment, etc. are also mitigated by the 25% overcollateralisation as well as by the dynamic nature and structure of the cover pool.

VI. TRANSPARENCY

As mentioned above (Section III, Cover Assets) Spanish legislation obliges Spanish issuers of covered bonds to keep a special and very complete register of their loans and credits. The annual accounts have to contain additionally the essential details of said register.

On top of that, main Spanish issuers of CH, coordinated by the Spanish Mortgage Association, and since the end of 2011, are endeavouring to create a transparency template, consistent with the guidelines of the ECBC Label Initiative. Said template is expected to be finalised before August 2012 and it shall be adopted by most Spanish credit institutions.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The institution issuing the cédulas will keep a special accounting register. Please refer to Section III on cover assets. The Spanish legislation does not require a special pool monitor other than the 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 29 July.

The issuer is also responsible and liable for cover and eligible assets pool monitoring. The quantitative mandatory limits have to be maintained at all times, thus the monitoring is carried out continuously by the issuer as a part of the risk management and auditing of its activity.

The "special" supervision - as per reference to UCITS Art. 52 (4) - is carried out by the *Comisión Nacional del Mercado de Valores* (hereinafter, "*CNMV*"). The CNMV may also monitor and supervise compliance with statutory requirements and limits upon approval of the issuance and clearly supervise the placing process

The role of the rating agencies shall be decided by the issuer on a case-by-case basis, either for commercial or market reasons, although as matter of fact most issues are rated.

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

Identification of the cover assets

Any mortgage that is originated in Spain must be registered in the Land Registry. Consequently, the Land Registry is the cover registry which records all the mortgages serving as the collateral for the CHs. The institution issuing the cédulas will keep a special accounting register.

Asset Segregation from the insolvency's estate.

Article 14 of the Law 2/1981 of the regulation of the mortgage market stipulates that the institution issuing the cédulas will keep a special accounting register. This provides the legal framework regarding the position of the rights of the holders of the CHs in case of insolvency of the Spanish issuer.

In this respect, it is worth pointing out the following relevant issues:

1. According to article 14 of Law 2/1981 claims of CH holders have to be treated as privileged claims against the insolvency estate (*créditos contra la masa*). Article 84.2.7 and article 154 of the Insolvency Law require that claims against the insolvency estate have to be paid by the insolvency administrators on their respective due dates without delay of payment, regardless of the status of the bankruptcy proceedings.

In the case of CH, the claims of the CH holders are secured by the entire mortgage loan book registered in favour of the CH issuer (article 12 of Law 2/1981) and if any, by the substitution assets which backup the cédulas hipotecarias and the economic flows generated by the financial instruments linked to each issue. The definition as stated by the Insolvency Law implies the application of the special rule of payment without enforcement of the collateral.

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

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

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

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

   All of the holders of cédulas hipotecarias, whatever their date of issue, shall have the same preference over the loans and credits covering them and if any, to the substitution assets which backup the cédulas hipotecarias and the economic flows generated by the financial instruments linked to each issue.

3. The payments to be effected by the debtor comprise all those deriving from principal and interest of the issued and outstanding CHs on the date on which the Insolvency is declared. All CH payments have to be met on their respective due dates, regardless of the status of the bankruptcy proceedings. In the case where the cover assets are insufficient to meet the CH payments, the claims of the CH holders will be realised. This realisation will not be subject to the 1 year term (or to the approval of the convention, if before) of "suspension or delay" provided for the execution of guaranties in rem pursuant to article 55.1 of the Insolvency Laws in the event of the alienation of properties and rights affected to the cédulas hipotecarias. The payment to all of the cédulas hipotecarias owners shall be done on a pro rata basis, regardless of the issue date of their securities. (art. 14 Law 2/1981). In the case of insufficient cover assets, all CH holders' claims will be met on a pro-rata basis together with ordinary claims (Art. 157.2 of the Insolvency Law).

   A judicial stay (moratorium) on the insolvency's estate cannot delay the cash flows from the cover assets and, therefore, endanger the timely payment of interest and the principle on CHs.

   In case of insolvency of the issuer, liquidity is ensured by the means discussed above, by the flows derived from the Cover Assets.

   In order to comply with the payment obligations to the holders of the cédulas hipotecarias in the event of a temporary gap in the revenue received by the debtor, payments shall be made by means of liquidating the substitution assets serving as collateral of the issue. If this was insufficient, payments shall be made by means of funding operations via subrogation of the debtor in the position of the holder of the cédulas (art. 14 Law 2/1981).

Administration of the cover assets

In case of insolvency, it is the normal insolvency administrator who administrates the cover assets. In this respect, under Spanish Insolvency Law, the bankruptcy is directed by commercial court of competent jurisdiction and managed by a specific body called the "bankruptcy authority" ("administración concursal") comprising three persons: an attorney, an auditor or accountant and a creditor with ordinary debt or general privilege.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The risk weight of the CHs that comply with the requirements of Law 2/1981 is dependent on the risk weight against the issuer, according to the following table:

Risk Weight against the issuer	CH's Risk Weight
20	10
50	20
100	50
150	100

(Rule 16, section L "Covered Bonds" of the Circular 3/2008, of 22 May, of the Bank of Spain)

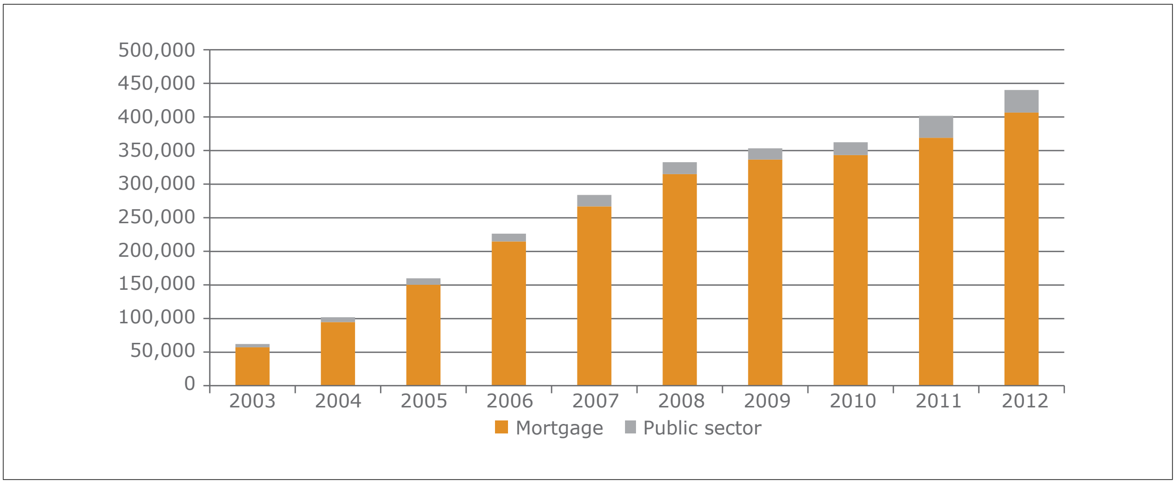
Provided that the requirements of the Law 2/1981 are met, the CHs are eligible as "Covered Bonds". The applicable law comprises Law 36/2007, of 16 November and Royal Decree 216/2008, of 15 February, by which Directives 2006/48/EC and 2006/49/CE, of 14 June 2006 are transposed into the Spanish Law. Next year provisions envisaged in the new Capital Requirements Regulation shall be of course applicable.

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

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

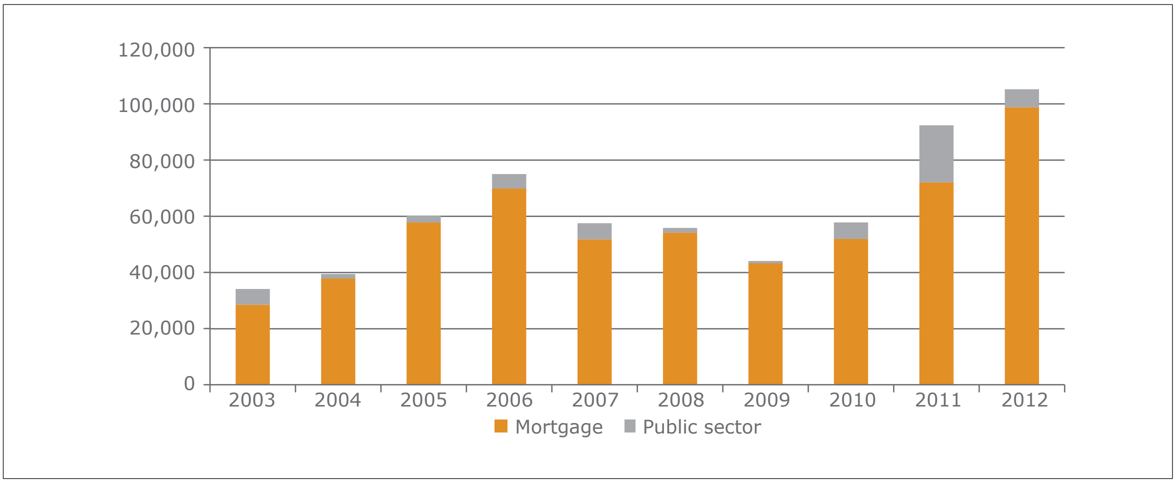
Finally, the CHs upon being listed or applied for listing are eligible for: i) investment by insurance companies of their technical provisions obligations; ii) the investment by mutual guarantee companies; iii) investment by Pensions Funds.

> Figure 1: Covered Bonds Outstanding, 2003-2012, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2012, EUR m



Source: EMF/ECBC

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/45/C%C3%A9dulas_Hipotecarias_-_CH

3.33 SWEDEN

By Jonny Sylvén, Association of Swedish Covered Bond Issuers (ASCB)

I. FRAMEWORK

In Sweden, the issuance of covered bonds is governed by the Swedish Covered Bonds Issuance Act, which came into force on 1 July 2004 (Lag 2003:1223 *om utgivning av säkerställda obligationer*, hereinafter the 'CBIA')[1]. The CBIA supersedes the general bankruptcy regulation and grants covered bond investors a priority claim on eligible cover assets (CBIA: Chapter 4, Section 1). A new regulatory provisions (FFFS 2013:01, hereinafter 'CBR')[2] established by the Swedish Financial Supervisory Authority (Finansinspektionen, hereinafter 'SFSA') complement the legislation. These regulations define in more detail the criteria for obtaining an issue licence, the universe of eligible cover assets, valuation procedures for eligible cover assets, asset and liability management, and the form and maintenance of the cover register.

II. STRUCTURE OF THE ISSUER

The CBIA does not apply the specialised banking principle but allows all banks and credit institutions to issue covered bonds provided they have obtained a special licence from the SFSA (CBIA: Chapter 2, Section 1). The issuer must meet certain criteria to qualify for the licence. These criteria include the submission of a financial plan proving the issuer's financial stability for the next three years, the conversion of outstanding mortgage bonds into covered bonds, and the conduct of business in compliance with the CBIA. The SFSA has the right to withdraw the licence should the institution be in material breach of the CBIA or have failed to issuecovered bonds within one year of receiving the licence (Table 1). If the SFSA withdraws a licence, the authority may 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 CBIA.
- The issuer must conduct the covered bonds business according to the CBIA and related regulatory provisions.
- Outstanding mortgage bonds to finance loans that may be includedf in the covered pool must be converted into covered bonds or administerd 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 sufficiently stable so that the interest of other creditors is not jeopardised when it issues covered bonds. The report must be substantiated by auditors.
- The issuers must submit an operational plan that calls for sound management and supervision of the covered bond business (including information of the IT business).

The SFSA may withdraw a licence if:

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

Source: Lag 2003:1223, FFFS 2013:01

1 Lag 2003:1223 om utgivning av säkerställda obligationer [Covered Bonds Issuance Act].
2 FFFS 2013:01 Finansinspektionen's Regulations and Guidelines regarding covered bonds.

Prior to the CBIA, commercial banks were restricted on their mortgage lending activities, and mortgage loans were extended by specialised mortgage institutions, which were allowed to issue mortgage bonds. Most of the Swedish mortgage credit institutions have a strong affiliation with Nordic universal banking groups, outsourcing their activities to their respective parent. The degree of outsourcing varies among issuers. The SFSA has published general requirements regarding outsourcing.

The cover assets represent claims of the covered-bond-issuing entity and remain on the balance sheet. There is no subsequent transfer of cover assets to another legal entity. The covered bonds are direct, unconditional obligations on the part of the issuer. Outstanding covered bonds are backed in their entirety by the cover pool. Hence, there is no direct legal link between single cover assets and particular covered bond series. In the event of issuer insolvency, the cover pool is bankruptcy-remote from the general insolvency estate of the issuer and exclusively available to meet outstanding claims ofovered bond holders. Moreover, covered bond investors enjoy ultimate recourse to the insolvency estate of the issuer, ranking pari passu with senior unsecured investors.

III. COVER ASSETS

Eligible cover assets are mortgage loans and public-sector assets (CBIA: Chapter 3, Section 1). The CBIA does not specify separate cover pools for mortgage and public sector cover assets. Both asset classes are mixed in one cover pool. However, the main emphasis of Swedish issuers is on mortgage covered bonds (more than 90 percent of cover pools).

Eligible assets are mortgages:

> on real estate intended for residential, agricultural, office or commercial use;

> on site-leasehold rights intended for residential, office or commercial use;

> pledged against tenant-owner rights; and

> against similar foreign collateral.

The CBIA restricts mortgages against offices and commercial property to 10% of the total cover pool. Mortgage loans can be secured only with collateral comprising property located in Sweden and the European Economic Area (EEA)[3]. Neither asset-backed securities nor mortgage-backed securities are permissible as cover assets. The mortgage loans must meet valuation procedures and certain loan-to-value ratios defined by the CBIA and the CBR (see section IV).

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

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

> issued by or guaranteed by a foreign state or central bank, where the investment is in the foreign state's currency and is refinanced by the same currency[4];

> issued by or guaranteed by the European Communities, or any of the foreign states, or central banks as prescribed by the Swedish government; or guaranteed by a foreign municipality or public body that has the authority to collect taxes.

The cover pool is a dynamic pool, and nonperforming loans due over 60 days cannot be recognised for the purposes of meeting the matching requirements set forth by the CBIA (CBR: Chapter 3, Section 4).

3 Countries belonging to the European Economic Area are the 28 EU countries plus Norway, Iceland, Liechtenstein.
4 The law does not provide for any explicit geographic restriction.

Derivative contracts

The CBIA provides for the use of derivatives for hedging interest and currency risk. The derivatives must be structured such that premature termination is not triggered by an issuer default or on demand of the counterparty. Derivative counterparties must have a minimum long-term rating of A3/A-/A- (Moody's/ S&P/Fitch) at the time the agreement is entered into . The law stipulates asymmetrical collateralisation, in that it requires collateral, a guarantee or replacement language in the event that the counterparty's rating falls below the minimum rating level. There is no reciprocal requirement by the covered bond issuer, given that derivative counterparties have a priority claim on the cover pool (CBR: Chapter 4, Sections 5 to 7). The use of derivatives is not limited to a maximum percentage of the cover pool since they are not included in the nominal matching calculation. Their use is limited to serve the balance between cover assets and outstanding covered bonds when creating a balance in respect of net present value of assets and liabilities.

Substitute assets

Highly liquid assets can serve as substitute assets for up to 20% of the mortgage cover pool. The SFSA can temporarily raise the limit to 30%. Eligible substitute assets include eligible public sector assets plus cash, cheques and postal money orders. These assets qualify for a 0% risk weighting. The SFSA has the discretion to extend the universe to eligible substitute assets (CBIA: Chapter 3, Section 2).

IV. VALUATION AND LTV CRITERIA

The CBIA defines valuation principles for properties that act as collateral for mortgages in the cover pool (CBIA: Chapter 3, Section 4). The valuation relating to residential properties may be based on general price levels. The valuation of any other eligible property class must be based on the market price, which must be determined by individual appraisal by qualified professionals. The market value should reflect the price achievable through a commercial sale, without time pressure and excluding any speculative or temporary elements. Issuers must monitor the market value of the property regularly, and in the case of serious decline must review the valuation, and ensure that the loan to value (LTV) of the related mortgage loan remains within the defined maximum limit (CBR: Chapter 3, Section 7, Chapter 5, Section 4). The valuer is normally an employee of the issuer, but external valuers are also used.

For the various mortgage types eligible as cover, the following maximum LTV ratios apply (CBIA: Chapter 3, Section 3):

> 75% of the value for real estate, site-leasehold rights and tenant-owner rights where the property is intended for residential use;

> 70% of the value for real estate intended for agricultural use;

> 60% of the value for real estate, site-leasehold rights and tenant-owner rights where the property is intended for office or commercial use.

These LTV limits are relative, not absolute, limits. A loan with a higher LTV ratio can be included in the cover pool up to the legal threshold. The balance must be refinanced with other funding instruments (e.g., senior unsecured funding) (CBR: Chapter 5, Section 3).

An issuing institution shall test and analyse how changes in property values may affect LTV ratios and the value of the cover pool. These tests shall at least be performed once a year. The tests should be based on conservative assumptions.

V. ASSET - LIABILITY MANAGEMENT

The CBIA requires that the nominal value of the cover assets all times exceeds at the aggregate nominal value of claims arising from outstanding covered bonds against the issuer (CBIA: Chapter 3, Section 8). In addition, the law requires that on a net present value (NPV) basis, cover assets, including derivatives, always exceed the corresponding value of the interest and principal of outstanding covered bonds, taking into account the effects of stress-test scenarios on interest and currency risk set by the SFSA. The SFSA defines the stress test for interest-rate risk as a sudden and sustained parallel shift in the reference swap curve by 100bps in an unfavourable direction, and a twist in the swap curve. Likewise, it defines currency risk as a 10% sudden and sustained change in the relevant foreign exchange rate between the currency of covered bonds and the currency of cover assets (CBR: Chapter 4, Section 3-5). The CBIA does not require a mandatory level of minimum overcollateralization (OC). However, the issuer can adhere to a self-imposed OC level for structural enhancement, as the CBIA protects any OC in the cover pool in the event of issuer insolvency.

Finally, the issuing institution shall ensure that the cash flow with respect to the assets in the cover pool, derivatives agreements and the covered bonds are such that the institution is always able to meet its payment obligations towards holders of covered bonds and counterparties in derivatives agreements (CBIA: Chapter 3, Section 9). The issuer should be able to account for these funds separately.

VI. TRANSPARENCY

The issuers are presenting information regarding their cover pool and outstanding covered bond every quarter in line with the national template. The information is today on every issuers' websites. Some of the issuer report more frequent then quarterly. The content of the national transparency template (posted on the Covered Bond Label website[5]) will be expanded if there are requests for it. Most of the issuers in Sweden have a special company that issue bonds. Those companies present quarterly or semi annual reports. Those reports have information regarding the company and its business. The issuer is required to feed the independent inspector with all kinds of information with a rather tight frequency. According to the new regulation from the Swedish FSA this year that information will be more detailed.

VII. COVER POOL MONITORING AND BANKING SUPERVISION

The covered bond issuers fall under the special supervision of the SFSA. The financial regulator monitors the institutions' compliance with the CBIA and other related regulatory provisions (e.g., CBR). If the covered bond issuer is in material breach of its obligations under the legal framework, the SFSA can issue a warning or revoke the issue license altogether. The SFSA may also revoke a license if the institution has declared that it waives the license or if the institution has not made use of the license within a year from the date of receiving the license. The revocation may be combined with an injunction against continuing the operations and with the imposition of a conditional fine. In any case, the SFSA must determine how the operations should be wound up (CBIA: Chapter 5, Sections 2 to 6).

For each issuing institution, the SFSA must appoint an independent and suitably qualified cover pool inspector (cover pool trustee), who is paid by the covered bond issuer. The duties of the cover pool inspector are to monitor the register and verify that covered bonds, derivatives agreements and the cover assets are correctly recorded. The inspector also ensures compliance with matching and market risk limits in accordance with the CBIA. Teh inspector must also, nowadays, review the revaluations of underlying collateral that has been conducted during the year. The institution is obliged to provide the covered bond inspector with any information requested relating to its covered bond operations. The cover pool monitor must submit a report of the inspection to the SFSA on

5 https://www.coveredbondlabel.com/issuers/national-information-detail/24/

an annual basis, and must notify the SFSA as soon as he/she learns about an event deemed to be significant to the supervisory authority (CBIA: Chapter 3, Section 12 to 14, and CBR: Chapter 6).

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

Cover register

The issuer must keep a register of eligible cover assets, substitute assets, derivative contracts, and outstanding covered bonds (CBIA: Chapter 3, Section 10). The law specifies the form and content of such a register, which must be easily accessible for the SFSA and the cover pool inspector. The registration legally secures covered bondholders and derivative counterparties a priority claim on the cover pool in the event of issuer insolvency (CBIA: Chapter 4, Section 4). Prior to an issuer being declared insolvent, cash flows accruing from the cover assets must be accounted for separately by the issuer. In the event of issuer default, covered bond investors and derivative counterparties have the same priority claim on these funds as they have on the cover pool. Moreover, cash flows accruing from the cover assets after issuer insolvency must be registered in the cover pool register.

Issuer is a subsidiary

Under the Swedish bankruptcy code, the mere insolvency of the parent company does not automatically trigger the insolvency of a subsidiary.

Issuer insolvency

In the event of issuer insolvency, the registered cover assets and the respective covered bonds are segregated from the general insolvency estate. covered bonds are not accelerated as long as the cover pool fulfils the requirements set out in the CBIA, notwithstanding the existence of 'only temporary, minor deviations' (CBIA: Chapter 4, Section 2).[6] Also, mere issuer default does not trigger the premature termination of registered derivative contracts. Covered bond holders and registered derivative counterparties have a priority claim on the cover pool and cash that derives from the pool, ensuring timely repayment to original agreed terms, as long as the pool complies with the CBIA. However, the cover pool does not constitute a separate legal estate. According to legal opinion, the bankruptcy of the issuer should not lead to a debt moratorium on covered bonds.[7]

Cover pool insolvency and preferential treatment

In the event that the cover pool breached eligibility criteria, covered bonds would be accelerated. covered bond investors and derivative counterparties would have a priority claim on the proceeds from the sale of the cover assets, ranking pari passu among themselves but prior to any tax claims and salary payments (pursuant to Section 3a of the Rights of Priority Act [SFS 1970:979]). If the proceeds are insufficient to repay all liabilities on outstanding covered bonds, covered bond investors and derivative counterparties would have an ultimate recourse to the insolvency estate of the issuer, ranking pari passu with senior unsecured investors.

Survival of OC

Any OC present in the cover pool at the time of issuer insolvency is bankruptcy-remote provided it is identified in the cover pool register. Indeed, the CBIA requires full repayment of outstanding claims on covered bonds, and registered derivatives, before cover assets would be available to satisfy claims on unsecured creditors.

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

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

7 There are no means in the Act that could disrupt or delay payment to covered bondholders. However, the Act does not explicitly derogate from the general provision of the Code of Procedures 1948 or the Bankruptcy Act 1987, of which neither explicitly ensures the integrity of payments on covered bonds.

right to use OC to pay advance dividends to other creditors of the bankrupt issuer, if the pool contains more assets than necessary.[8] If the cover assets later prove to be insufficient, these advance dividend payments can be reclaimed.

Access to liquidity in case of insolvency

In the cases of issuer insolvency, the law does not enable the receiver-in-bankruptcy to refinance maturing covered bonds of the issuing institution by issuing new covered bonds against the cover pool. Likewise, the receiver is not able to substitute ordinary cover assets for alternative assets. However, the receiver can use available liquid substitute assets included in the pool. In addition, the receiver can sell part of the cover pool in the market to create the necessary liquidity without raising debt.

The receiver-in-bankruptcy has – as of the 1 June 2010 - also got an express mandate, on behalf of the bankruptcy estate, to take out liquidity loans and enter into other agreements for the purpose of maintaining matching between the cover pool, covered bonds and derivative contracts. The receiver has an extensive mandate to enter into agreements, not only to achieve a liquidity balance but also to achieve a balance in respect of currencies, interest rates and interest periods. The receiver should only enter into agreements if, on the date of execution of the agreement, the agreement is deemed to favour bondholders and derivative counterparties and if the assets in the cover pool are deemed to fulfil the terms and conditions imposed in the Act. When the receiver enters into an agreement the contracting party receives a claim against the bankruptcy estate that ranks ahead of the secured creditors and creditors with rights of priority.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Swedish covered bonds comply with the criteria of UCITS 52 (4) and with the covered bond criteria defined in the EU CRD Directive, Annex VI, Part 1, Paragraph 68 a) to f). The CBIA explicitly lists mortgages against property for agricultural purposes, and mortgages against the pledging of tenant-owner rights as eligible cover assets, while the EU CRD does not. However, general opinion of the parties involved is that the EU CRD's term "commercial real estate" should be interpreted in a broader sense, including agricultural property. In addition, issuers can impose self restrictions to ensure that their covered bond issues comply with EU CRD. Swedish covered bonds are eligible for repo transactions with the Riksbank (the Swedish Central Bank). The share of the total collateral in relation to the payment system that can be comprised of covered bonds is 100 per cent. This applies to covered bonds issued by the borrower or by an institution with close links to the borrower.

The Riksbank's collateral requirements are harmonised with those applied within the Eurosystem. Moreover, Swedish covered bonds denominated in euros are likely to qualify as Tier 1 assets with the ECB.[9]

Derivatives that are part of the cover pool do not benefit from any special capital treatment. They currently carry the same risk weighting as the credit institution counterparty. The implementation of EU CRD into Swedish law grant derivative contracts included in the cover pool the same capital treatment as covered bonds.

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

8 According to legal opinion, the receiver-in-bankruptcy would have take into account a substantial safety margin to ensure that the cover pool's integrity and compliance with the Act is not jeopardized, which would be difficult to prove unless outstanding covered bonds were due to mature imminently.

9 In general, the ECB grants marketable debt instruments the status of Tier 1 assets, if the security is denominated in euros, compliant with UCITS Art. 52 (4) and issued by a credit institution situated in the EEA area (ECB: "Implementation of Monetary Policy in the Euro Area", Feb, 2005).

The law regulating insurance companies in Sweden (Försäkringsrörelselagen 1982:713) makes no distinction between mortgage bonds and covered bonds. Swedish insurance companies can invest up to a maximum of 25 % in the covered bonds of a single issuer. Swedish legislation on investment funds (Lag 2004:64 om investeringsfonder) allows mutual funds to invest up to 25% of their assets in Swedish covered bonds, instead of the 10% generally applicable to other asset classes.

X. ADDITIONAL INFORMATION

Issuing and trading of Swedish domestic covered bonds

In order to issue covered bonds mortgage companies and banks need an authorisation by the Swedish Financial Supervisory Authority (SFSA). Normally the bonds are registered at the Nordic Exchange Stockholm (NASDAQ OMX Group), although no actual bond trading takes place there. Offering circulars with the detailed issue conditions are following a standard based on the Prospectus Directive with acceptance from the SFSA, OMX and the market makers. The normally used technique for issues is "on tap".

The Swedish bond market investors appreciate liquidity. Because of these "requirements" the large issuers issue their bonds as benchmarks which mean that large amounts (SEK 3 billion and more) are issued and that a number of dealers, under normal circumstances, show both bid and offer prices. Also, only benchmarks are deliverable in the future contracts. When a new benchmark-loan is issued, the issuers make sure that the amount issued meets the requirements for a benchmark sized deal. After the initial day of issuance the issuer can, without further notice, issue "on tap" the size he requires to match the lending.

The bonds are sold into the primary market through banks acting as agents for the issuer. These banks also act as market makers in the secondary market. Currently, there are six banks and securities firms that act as market makers in covered bonds: Danske Bank, Nordea, Nykredit, SEB, Svenska Handelsbanken and Swedbank. The market for government and domesticcovered bonds, as well as treasury bills, is a telephone and screen-based over-the-counter market. Market makers display indicative two-way prices on an electronic information system which is instantaneously relayed by Reuters. Fixed prices are quoted on request and most deals are concluded via telephone. Trading in the secondary market takes place on all business days between 09.00 and 16.15 (local time). The number of bonds to be quoted is regulated in an agreement between the issuer and the market-maker.

Bonds are quoted on a yield basis with bid and ask spread of (under normal market conditions) 2 bp for the liquid benchmark bonds. The settlement day for bonds is three business days after the trading date. T-bills are quoted on a simple yield basis and are settled two business days after the trading day. The normal trading lot in government securities and liquid mortgage bonds is SEK 200-500m. Of course, prices are given for other lots as well.

Sweden has a liquid and smoothly operating repo market with almost all banks and broker firms involved in the trading. The repo market in Sweden started in the late 1980s, and has developed fast over the last few years. The Swedish Debt Office offers a repo-facility in government bonds and treasury bills and mortgage companies offer their market makers a repo-facility in their own bonds. The repo transaction is viewed as a 'sell-buy back' or 'buy-sell back' deal and the ownership of the security has to be transferred. There are no standard conditions for a repo transaction and the counterparties have to agree on maturity, settlement day and delivery for each deal. Most often, though, repos are settled two banking days after the trading day. Repo rates are qoted as a spread vs the Riksbank repo rate.

Almost all public listed securities in Sweden are registered at the Euroclear Sweden. In general, Swedish bonds are domestically settled via the Euroclear. Domestic settlement requires a custodian account with one of the Swedish banks or securities firms. Foreign investors can either have a custodian service with a Swedish bank or securities firm or settle via Euroclear or Cedel.

Accrued interest is calculated from the previous coupon date to the settlement day. The interest rate is calculated by using ISMA's 30E/360 day count - "End-of-month" convention.

Swedish government and covered bonds have five ex-coupon days which means that there is negative interest when settlement occurs within five business days before the coupon date.

Most Swedish bonds pay coupon annually. There are, however, bonds that pay coupon semi-annually. All domestic banks act as paying agents.

Swedish krona bonds redeem at par upon maturity.

A special small bond Exchange called "SOX", is a special part of NASDAQ OMX Nordic. All bonds registered at "SOX" must have low denominations in order to be suitable for private investors. The trade in the "SOX" market is held by the Swedish Commercial banks and some stock brokers.

The trade in the SOX market is fully computer based. A normal "trading amount" in the SOX market is SEK 100.000 per transaction.

The activities of ASCB

The Association of Swedish Covered Bond issuers (ASCB), which was established in 2009, has an ongoing work to further improve the conditions for the Swedish covered bonds. Two recent results of these efforts are firstly an amendment of the law with the purpose to grant the receiver-in-bankruptcy access to short-term liquidity in case of insolvency (see chapter VII) and secondly an agreement on the method of calculating the LTV for the cover pool.

According to the agreement the Swedish covered bond issuers are recommended to calculate and present certain basic key statistics concerning their respective cover pools as uniformly as possible ("Max LTV per property").

> Cover pool data shall comprise only loans and collateral included in the pool. When a loan is only partially included in the pool, only the eligible part is accounted for.

> In case a loan is secured by both mortgage deeds and a guarantee from the state or municipality, the part of the loan with guarantee will be treated as a public loan, and not included in LTV calculation.

> Loan to Value will be calculated on the principal only.

> Calculation of the aggregate weighted average LTV for a cover pool, will follow a method called "Max LTV per property". The method is chosen because it is fairly simple and the result is independent of the number of loans or mortgage deeds charging a property. It is also independent of the order of priority for the individual mortgage deeds.

The weighted average LTV should be supplemented with a diagram showing the distribution of principal balance in "LTV buckets" based on the exact order of priority for the individual mortgage deeds. In ECBC national template for transparency this LTV is used. The national template has been developed during the last year to get the Swedish issuers to comply with the requirements for the Covered Bond Label, which the Swedish issuers have achieved.

The Swedish issuers of covered bonds made in April 2013 a joint road show in Tokyo and Hong Kong. Presentations were made by Mattias Persson, Head of the Department for Financial Stability at the Riksbank, Torbjörn Isaksson Head of Research at Nordea and Louise Bergström, Head of Investor Relations at SBAB. The presentations concerned the Swedish economy, the housing market, the covered bond market, the legal framework and the credit infrastructure.

Further information concerning the road show, the LTV-method as well as the Swedishcovered bond market is accessible at the website of ASCB (www.ascb.se).

Essential Terms and conditions of a typical Swedish market maker agreement

The market maker has a duty

> Help the issuer sell bonds via taps of the benchmark loans in the market;

> Actively support trading of these bonds in the secondary market; and

> Continuously quote indicative rates in the information systems used.

These obligations apply to a limited number of the issuer's loans – the benchmark-loans. Typically 5 to 8 loans of a big issuer have this status with respect to outstanding volume. Using the on-tap issuing technique a loan typically reaches bench-mark status when the outstanding loan amount is SEK 3-5 bn. (At the peak of the life of the bond it typically has a volume of SEK 50 to 70 bn. After that the volume falls due to active repurchase operations by the issuer. With one year to go to maturity a loan is no longer of benchmark status. This paves the way for a controlled redemption of the remaining part of the loan.)

The bid ask spread shall be in line with present market conditions and the trading lots shall typically exceed SEK 500 million.

The obligations of a market maker are conditional upon a number of things of which the following could be mentioned;

> that no change in the economic, financial or political conditions have occurred which in the reasonable opinion of the market maker would create a major obstacle to the fulfilment of the obligations;

> that the bonds, in the reasonable opinion of the market maker, cannot be placed in the primary or secondary market on normal market conditions.

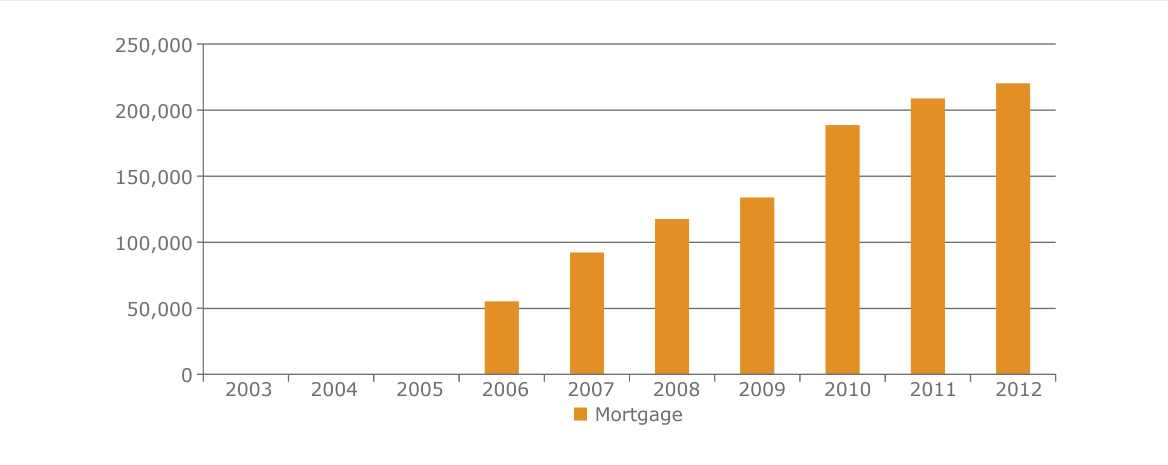
If so, the market marker shall notify the issuer and may withdraw from the duties wholly or in part for a shorter or longer time.

The market maker also has an obligation to trade two futures (2 and 5 year) of the issuer in a similar way as that of the benchmark bonds..

The issuer on his side has an obligation to (under normal market conditions) supply the market maker with a repo facility in the outstanding benchmark bonds. (This facility used to be unlimited. Today however the limit is set by the available cover in the cover pool of the issuer.)

With respect to transparency the issuer shall make public at the end of each week figures on outstanding benchmark loans as of the last day of the previous week.

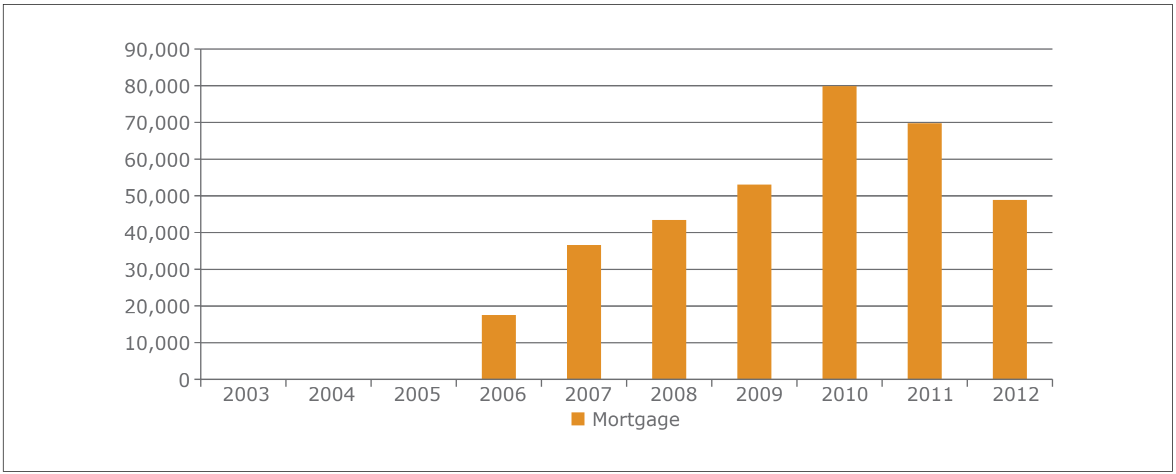
> Figure 1: Covered Bonds Outstanding, 2003-2012, EUR m



Source: EMF/ECBC

Notes: The first covered bonds were issued in 2006 with the application of the Covered Bond s Issuance Act. Prior to 2006 only mortgage bonds were issued in Sweden and as they are not directly comparable to covered bonds they are not included in the figures. In the graph only covered bonds are present.

> Figure 2: Covered Bonds Issuance, 2003-2012, EUR m



Source: EMF/ECBC

Issuers: The Swedish covered bonds market in 2012 consists of seven issuers: Stadshypotek, Swedbank Mortgage, Nordea Hypotek, Swedish Covered Bond Corporation (SCBC), SEB, Länsförsäkringar Hypotek and Landshypotek. The market is dominated by the first five of them and the majority of their exposure is to domestic residential mortgages, with the remainder consisting of commercial property loans and public sector loans.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/47/Swedish_Covered_Bonds

3.34.1 SWITZERLAND – SWISS PFANDBRIEFE

By Jörg Schmid, Pfandbriefbank schweizerischer Hypothekarinstitute AG

I. FRAMEWORK

The issuance of Swiss Pfandbriefe – a label protected by law - is governed by the 'Pfandbriefgesetz' (PfG) effective 25 June 1930. Since then the PfG was only marginally modified. It contains only 52 articles and is complemented by the 'Pfandbriefverordnung' (PfV) and the valuation regulations.

The Swiss Pfandbrief is more than a mere covered bond because in case of the Swiss Pfandbrief the coverage is legally determined in comparison to a covered bond with a coverage which is only based on a private agreement between issuer und investor.

As of article 1 of the PfG the Pfandbrief institutes have the purpose to grant real estate owners long term mortgages at constant and cheap interest rates. Generally speaking, the Swiss Pfandbrief is a major means to close the refinancing gap of member banks.

II. STRUCTURE OF THE ISSUER

The PfG grants the right to issue Swiss Pfandbriefe exclusively to two Swiss Pfandbrief institutes, namely the Pfandbriefzentrale der schweizerischen Kantonalbanken AG (PBZ) and the Pfandbriefbank schweizerischer Hypothekarinstitute AG (PBB). The first operates as the Pfandbrief issuing vehicle of the Swiss cantonal banks and the latter of all other Swiss banks. The PfG grants these two institutes the right to merge. Both are special banks with their business scope limited to the issuance of Swiss Pfandbriefe, to granting loans to their member banks and to investing their share capital and reserves. They are owned by their member banks.

The cantonal banks are public-sector banks and majority-owned by the canton (Swiss region) in which they are incorporated. Most cantonal banks benefit from a state guarantee extended by their canton[1].

To issue Swiss Pfandbriefe the authorisation of the government is required. Both Pfandbrief institutes are supervised by the Swiss banking regulator, the Eidgenössische Finanzmarktaufsicht (FINMA).

Even if it looks like it at first glance, it is not a duopoly. The two Pfandbrief institutes are self-help-organizations, or in other words, the bond issuing departments and cover pool of their member banks outsourced to the Pfandbrief institutes. Switzerland is too small a country for every bank to issue Swiss Pfandbriefe. Pooling makes sense and is an additional strength.

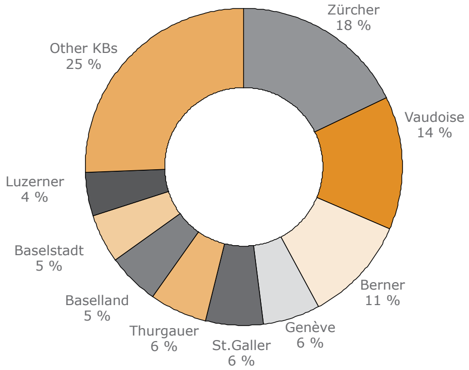
PBZ was founded in 1931 and has 24 member banks. Only cantonal banks have the right to be members of the PBZ (PfG Art. 3). PBZ does not have its own staff but has fully outsourced its operations to Zürcher Kantonalbank. As of 31 December 2012 the total outstanding Swiss Pfandbriefe of PBZ amount to CHF 29.3 billion (EUR 24.3 billion).

PBB was founded in 1930 and counts 269 member banks. Any Swiss bank has the right to become a member of PBB, provided that it is headquartered in Switzerland and that Swiss mortgages account for at least 60 % of the bank's balance sheet. The board of directors can accept banks with a lower mortgage/balance sheet ratio. As of 31 December 2012 the total outstanding Swiss Pfandbriefe of PBB amount to CHF 52.4 billion (EUR 43.4 billion).

1 Three of PBZ's member banks do not benefit from a cantonal guarantee or have a limited guarantee, namely Banque Cantonale de Genève AG (limited guarantee until 2016), Banque Cantonale Vaudoise AG (no guarantee) and Berner Kantonalbank (no guarantee).

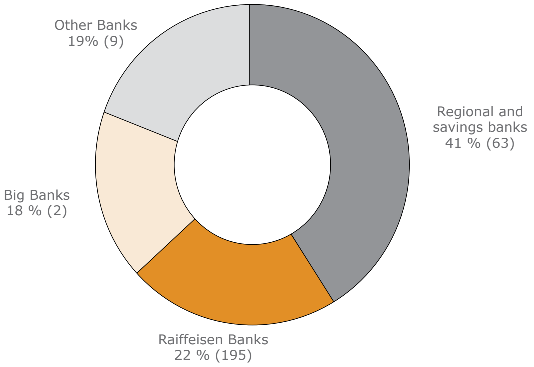
The figures below shows the structure of the shareholders:

> FIGURE 1: SHAREHOLDERS OF PBZ



Source: PBZ, as of 31.12.2012

> FIGURE 2: SHAREHOLDERS OF PBB



Source: PBB, as of 31.12.2012

From the beginning Moody's has rated Swiss Pfandbriefe with Triple A. The Swiss National Bank accepts Swiss Pfandbriefe as collateral for the repo pool (CHF GC Basket).

Swiss Pfandbriefe are standardized to a great extent. They are a commodity, denominated only in Swiss francs, with an original time to maturity between 3 and 30 years and always with a fixed coupon. They are issued at the due date of a matured Pfandbrief, if the conditions for a new issuance are favourable or tailor-made on the basis of an investor demand. The size of an issuance depends either on the demand of the member banks for loans or on the demand of the investors for Swiss Pfandbriefe, whichever is smaller. The average size is about CHF 583 million. Whenever possible, existing bonds are reopened. The maximum size should not exceed CHF 1 billion.

Swiss Pfandbriefe are issued either as public bonds or as private placements. Public bonds are issued through a banking syndicate at fixed conditions, while private placements are issued by the Pfandbrief institutes themselves.

The issuing price or investor's yield depends on the duration of a bond, the interest curve, the coupon and the issuing volume. Further pricing information is obtained from the secondary market of all other outstanding Swiss Pfandbriefe and from the comparison with other bond issuers. For example: On 31 January 2013 PBB issued three series with a total volume of CHF 0.6 bn: Series 579, 5 years with swap mid -3 bp, series 576 2A, 11 years with swap mid +1 bp and series 574 2A, 17 years with swap mid +5 bp.

All of the about 135 publicly issued Swiss Pfandbriefe are listed on the SIX Swiss Exchange. Swiss Pfandbriefe amount to 26 % of all Swiss domestic bonds listed (in Swiss francs). Private placements are not listed.

The total volume of all outstanding Swiss Pfandbriefe as of 31 December 2012 amounts to CHF 81.7 billion (EUR 67.7 billion). For years the two Swiss Pfandbrief institutes have been the major bond issuers in Switzerland, even more important than the government. In 2012 they issued Swiss Pfandbriefe amounting to CHF 15.5 billion (EUR 12.8 billion).

About 30 % of investors in Swiss Pfandbriefe are institutional investors (such as asset managers), 25 % investment funds and banks, 19 % insurances, 10 % pension schemes and the rest are retail investors and others.

III./IV. COVER ASSETS, VALUATION AND LTV CRITERIA

As a principle, Swiss Pfandbrief loans are only given against a pledge of first rank mortgages on Swiss properties. Within PBZ the cover pool is managed by the member banks.

PBB has got an electronic cover pool. Mortgages are pledged to PBB by member banks through entry of the "cover proposal" into the electronic pool register, which all 269 member banks are linked with. The system immediately evaluates the member bank's "cover proposal", which is then reviewed by one employee and authorized by another. The valuation of PBB is independent of the valuation of the member bank. Substantial cover proposals are reviewed by the cover pool committee. Member banks can check on their screen, whether its "cover proposals" are accepted or refused for improvement.

PBB supervises the cover pool electronically. If coverage tends to become insufficient, an exception list is produced and the member bank will be informed automatically. Based on PfG, member banks are obliged to increase coverage in case of impaired or non-performing mortgage loans or if total interest payable of the Pfandbrief loans is smaller than the total interest receivable on the pledged mortgages.

The "Pfandbriefbank pool" (of PBB) consists of more than 130,100 mortgages all over Switzerland, which provides a good diversification. 97.9 % are residential and only 2.1 % commercial properties. Details on "Pfandbriefbank Pool" are published semi-annually. These details are in line with the 'Covered Bond Label' self-certification, although Switzerland does not participate in the programme.

The PfG defines the maximum loan to value (LTV) of two thirds (Art. 5 PfG) and the valuation principles, which are detailed in the valuation regulations and approved by the federal council. FINMA can ask for a reassessment of the collateral if its market value or other economic conditions have deteriorated substantially.

In total about 9.5 % of all Swiss mortgages are financed through Swiss Pfandbriefe.

V. ASSET - LIABILITY MANAGEMENT

Cover principles

The PfG stipulates that the principal amount and interest payments of outstanding Pfandbriefe be at all times covered by an equivalent amount of loans to the member banks (PfG Art. 14). The Pfandbrief loans granted by Swiss Pfandbrief institutes to their member banks must be collateralised by eligible liens on real property (PfG Art. 19). The Pfandbrief institutes will only pay out Pfandbrief loans to member banks if the cover value of the cover register asset pool meets the criteria of the PfG.

Overcollateralization

Additionally to eligibility and valuation principles (LTV legally at maximum 2/3, in reality less than 50 % as mentioned above), the cover value of the cover register assets have to exceed the Pfandbrief loans given to member banks at least by 8 % within PBB und by 15 % within PBZ. The higher percentage of PBZ compensates the fact that PBZ does not have an electronic cover pool register.

Additional Risk Limits

Swiss Pfandbriefe are issued in individual series which must match the repayment profile of the Pfandbrief loans to member banks, eliminating interest rate and funding risks. Currency risk does not exist as both the loans to member banks and the Pfandbriefe are issued in Swiss Francs. Therefore, there is no need for derivatives to hedge market risks. Liquidity concentration risk is limited by individual limits for each member bank. The investment policy for free assets limits credit and market risks on counterparty and portfolio level.

Growth of the Pfandbrief institutes is limited as the required capital must exceed 2 % of the total Pfandbrief issuance volume of the respective institute (PfG Art. 10).

VI. TRANSPARENCY

Key data	Units	PBB	PBZ
As of		31.12.2012	31.12.2012
Swiss Pfandbriefe outstanding	CHF bn	52.4	29.3
Average interest rate for outstanding Pfandbriefe	%	2.003	2.128
Balance sheet total	CHF bn	54.3	30.6
Free Assets	CHF bn	1.2	0.6
Equity capital	CHF bn	1.3	1.0
Moody's rating		Aaa (stable)	Aaa (stable)

Both institutes publish more information on the websites listed below.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

PBB valuates the cover pool independently of the member bank (who grants the mortgage to the house owner) and monitors eligibility and overcollateralization of the cover pool daily. All mortgages are back-tested by a hedonic valuation model. Additionally the cover pool committee reviews substantial mortgages and visits major properties.

Swiss government approves by-laws and valuation regulations and nominates one member of the board of directors.

External audit firms audit the financial statements and the cover pool of the member banks and the Pfandbrief institutes. The auditors report directly to the banking supervision (FINMA) and the general assembly.

In addition, Moody's rates all Swiss Pfandbriefe with Aaa, investors analyse the annual reports of the Pfandbrief institutes, analysts of the big Swiss banks Credit Suisse, UBS and Zürcher Kantonalbank publish research reports and last but not least capital market values Swiss Pfandbriefe on a daily basis.

For the issuing of Swiss Pfandbriefe a special license of the FINMA is required. Swiss Pfandbrief institutes and their member banks are supervised by FINMA.

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

In the event of the insolvency of a member bank, the Pfandbrief institute has a priority claim on the registered collateral (PfG Art. 23). The insolvency of a member bank does not trigger the acceleration of outstanding Pfandbriefe because the investors have no direct contractual relationship with the member bank. In this respect, the Pfandbrief institute functions as a buffer between the investors and the member banks. FINMA cannot delay payments on the Pfandbrief institute's claims, which are themselves backing the Pfandbriefe (BankG Art. 26, Abs. 1, h). Moreover, FINMA can demand the transfer of the collateral pool under its control and then act as fiduciary (PfG Art. 40) or arrange for a sale of the cover assets to other banks[2].

Timely payments on Pfandbriefe are ensured, even if one or several member banks default. First, the Pfandbrief institutes collect the interest on the member loans on a semi-annual basis while coupon payments on Pfandbriefe are annual. Second, the Pfandbrief institutes have own funds at their disposal and maintain a portfolio of liquid investments.

The insolvency of a Pfandbrief institute is highly unlikely as it could only occur if several member banks defaulted at the same time, combined with a severe deterioration of the cover pool. Moreover, FINMA is highly likely to use supervisory efforts to avoid a bankruptcy of a Pfandbrief institute. In the improbable scenario of

2 In the early 1990s, Spar- und Leihkasse Thun, a member bank of PBB, no longer met regulatory capital requirements and was closed by the FINMA. Cover pool mortgages were sold to other banks and the proceeds were used to amortize the loans granted by PBB.

bankruptcy of a Pfandbrief institute, Pfandbriefe would accelerate and Pfandbrief investors would rank pari passu among themselves on the proceeds of the asset sale (PfG Art. 29). Again, FINMA has the power to assume control of the respective cover pool and to act as fiduciary.

IX. RISK-WEIGHTING

Switzerland implements Basel III into national law (Swiss Capital Adequacy Ordinance, CAO). The CAO has two approaches to measure credit risks in banking books: The BIS standard approach and the internal ratings-based approach. Under the BIS standard approach Swiss Pfandbriefe have a 20 % risk weighting.

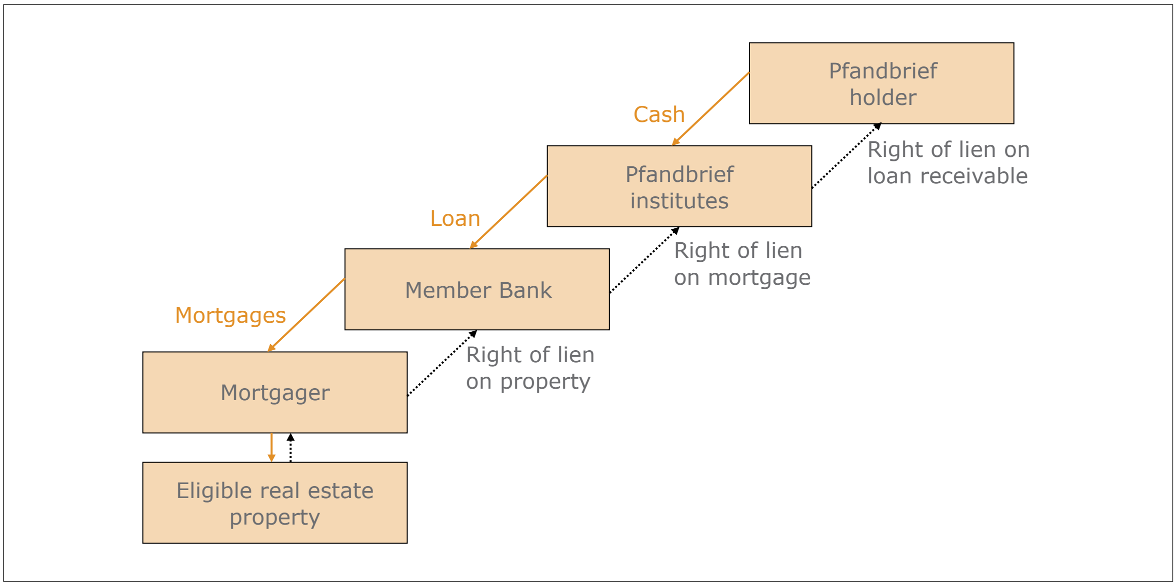
X. ADDITIONAL INFORMATION

Investor benefits

An investor in Swiss Pfandbriefe benefits from:

- The special bank principle with no currency and no interest change risk.
- The cover pool, which only includes mortgages on Swiss properties and thus excludes ship or airplane mortgages, derivatives, foreign mortgages etc.
- The fourfold security which is 1) the creditworthiness of the Pfandbrief institute, 2) the creditworthiness of the member bank, 3) the creditworthiness of the proprietor of the property and 4) creditworthiness of the property itself.
- In the case of PBZ: Explicit state guarantee for most of its member banks.
- In the case of PBB: The value of the property is determined by PBB and not by the member bank.
- The fact that since the establishment of the PfG in 1930 neither an investor nor a Pfandbrief institute have ever suffered a loss.

> Figure 3: The Swiss Pfandbrief Model



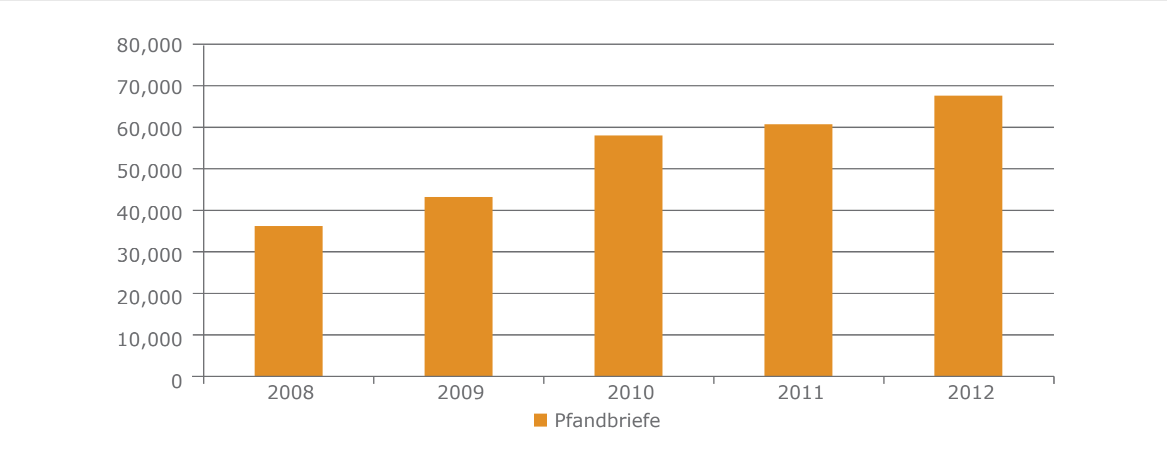
Source: Credit Suisse AG

Contact addresses

For PBB: Pfandbriefbank schweizerischer Hypothekarinstitute AG
Nansenstrasse 16
CH-8050 Zürich
+41 44 315 44 55
www.pfandbriefbank.ch

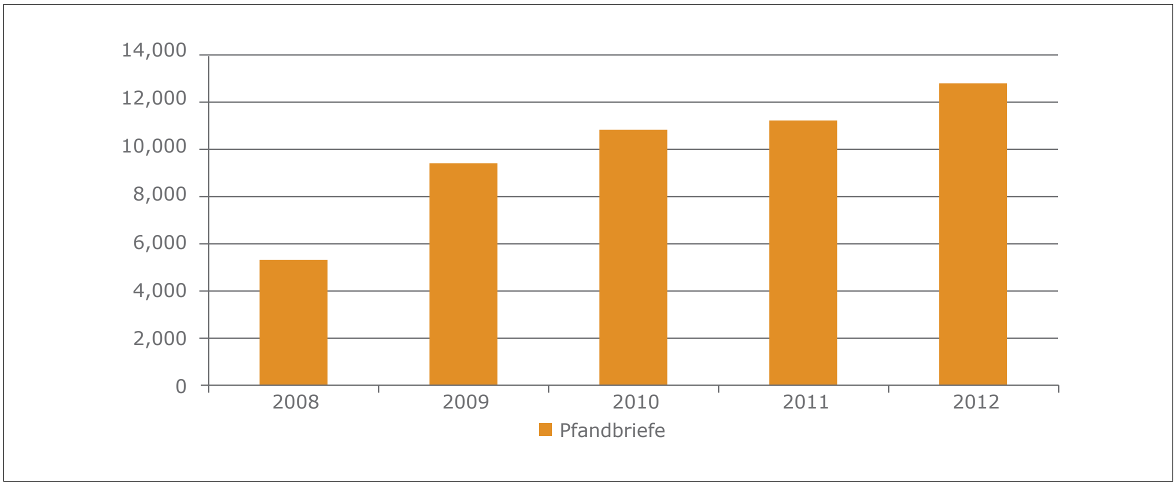
For PBZ: Pfandbriefzentrale der schweizerischen Kantonalbanken AG
Bahnhofstrasse 9
CH-8001 Zürich
+41 44 292 31 97
www.pfandbriefzentrale.ch
www.cldg.ch (French)

> Figure 4: Swiss Pfandbriefe Outstanding, 2008-2012, EUR m



Source: EMF/ECBC

> Figure 5: Swiss Pfandbriefe Issuance, 2008-2012, EUR m



Source: EMF/ECBC

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/82/Swiss_Pfandbriefe

3.34.2 SWITZERLAND - STRUCTURED COVERED BONDS

By Richard Kemmish, Credit Suisse and Ulrike Hock, UBS

In addition to instruments issued under the Swiss covered bond act, the Swiss Pfandbriefe as described above, two Swiss banks (Credit Suisse and UBS) have chosen to establish covered bond programmes based on contractual agreements with the relevant parties. Instruments issued under such contractual agreements qualify as structured covered bonds that allow Credit Suisse and UBS to also access the deeper liquidity of the non-CHF denominated covered bond market.

In line with the Swiss Pfandbriefe, the programmes are both backed by prime Swiss domestic residential mortgage collateral.

Given that the two covered bond programmes are based on contractual agreements, the issuers have been free to include various structural features designed to enhance investor protection and ensure a robust AAA/Aaa rating. Both of the programmes launched to date have adopted very similar structures, the minor differences are highlighted where appropriate below.

I. FRAMEWORK

Although not relying on the Swiss covered bond act, both programmes use Swiss (as well as English) legal frameworks to ensure, inter alia, a segregation of the assets and the bankruptcy remoteness of the guarantor.

The issuers have separately mandated two Swiss-based special purpose companies (Credit Suisse Hypotheken AG and UBS Hypotheken AG) to guarantee their payment obligations for the benefit of the covered bondholders. The guarantee then comes into operation following an issuer event of default, subject to certain conditions. All covered bonds issued under the respective programme rank pari passu with each other and share equally in the security. Furthermore, the covered bonds are either fungible with an existing series, or constitute a new series with different terms.

The guarantors are ring-fenced, bankruptcy-remote entities that will be unaffected by the insolvency of the group to which they are consolidated (both guarantors are majority-owned by their respective issuer).

II. STRUCTURE OF THE ISSUER

Both issuers today are large financial institutions regulated by the Swiss banking regulator, "Swiss Financial Market Supervisory Authority" (FINMA).

The covered bonds issued by Credit Suisse and UBS are direct, unsubordinated, unsecured and unconditional obligations benefiting from a guarantee given by the respective guarantor vehicles. Before an issuer event of default, the issuers shall make all payments of interest and principal on the covered bonds.

III. COVER ASSETS

In both programmes, the collateral consists of Swiss mortgage loans to private individuals and the related mortgage certificates securing such mortgage loans. The geographical scope for the mortgage assets is limited to Swiss domestic mortgage loans.

Substitution assets can be included in the cover pool. Their aggregate value can make up to a maximum of 15% of the cover pool and may consist of cash and short-term investments such as bank deposits, domestic Pfandbrief bonds and AAA government debt.

In order to ensure that the overcollateralisation (OC) level is compatible with the triple-A rating objective, the programmes include a dynamic Asset Coverage Test (ACT) that requires the balance of the mortgages in the collateral pool to significantly exceed the balance of the outstanding covered bonds. The level of OC will depend on the credit quality of the mortgages in the cover pool as well as other risks as assessed by the rating agencies.

IV. VALUATION AND LTV CRITERIA

For Credit Suisse, the LTV limit is set at 70% while for UBS at 80%. When calculating the appropriate loan balance within the asset coverage test (ACT), Credit Suisse allows higher LTV loans to be included in the pool, but loan amounts exceeding the cap are disregarded. For Credit Suisse, the LTV ratio of the mortgage loans cannot be more than 100%. UBS does not allow loans with LTV above 80% to be included in the Cover Pool, and if this LTV cap is breached after inclusion the loan amounts exceeding the cap will be credited with a reduced multiplication factor. In addition, the ACT gives reduced value to loans more than 90 days in arrears.

For both programmes LTV is calculated using market values.

For all properties that comply with its standard valuation boundaries (e.g. value below CHF3mn or property less than 15 years old) Credit Suisse utilises a hedonic automatic valuation model provided by IAZI, one of the two main providers of such automated appraisals in Switzerland. Should the purchase price lie above 15% off the IAZI valuation, Credit Suisse performs an onsite valuation of the property (this also applies for properties that fall outside the valuation boundaries).

UBS uses a hedonic automated valuation model from Wüst&Partner (the second main provider) for all loan applications. W&P and IAZI together value about two-thirds of all residential property transactions in the country. Input factors for the W&P model are property characteristics such as year of construction, volume of property and net living space. Additionally, the property's positioning within the local area and macro-level information (e.g. accessibility, tax level and price level of the municipality) are taken into account. If UBS deems on-site valuation as appropriate these will by specialist UBS staff (e.g. engineers or architects).

V. ASSET-LIABILITY MANAGEMEMT

Both covered bond programmes benefit from a number of safeguards:

> Exposure to market risk (i.e. interest rate and currency risks) needs to be neutralised by use of derivatives. Subject to certain rating triggers, swaps with suitable counterparties have to be entered into to ensure that exposure to market risk is properly hedged;

> Liquidity risk is mitigated by the requirement to establish a reserve fund as well as by other contractual arrangements. All of the bonds issued to date have a pre-maturity test to ensure repayment of the bonds on a hard bullet basis (although other structural enhancements, such as extensions, are available to the issuers if in future investors or rating agencies prefer it);

> Cash flow adequacy is secured through the asset-coverage and interest-coverage tests and the contractual obligation to neutralise any exposure to interest rate and currency risk;

> Commingling risk is mitigated by the hedging strategy as well as the requirement of all collections arising from the cover assets to be swept into the Hypotheken accounts after loss of F1/P-1 short-term ratings of the issuers;

> Minimum rating requirements are in place for the various third parties that support the transaction, including the swap counterparties and account banks. There are also independent audits of the calculations undertaken on a regular basis;

As a default of the issuer does not accelerate the covered bonds, an amortisation test has been created to ensure that no time subordination exists between the covered bonds series. The amortisation test will fail if the aggregate loan amount falls below the outstanding balance of all the covered bonds.

VI. TRANSPARENCY

Both issuers have committed to publishing monthly investor reports on a timely basis.

These reports provide various information relevant to investors including,

> the monthly calculations of the Asset Coverage Test and the Interest Coverage Test,

> details of outstanding covered bonds and list of parties involved in the transaction,

> balance of programme accounts,

> a mortgage portfolio summery outlining total contract balance, average loan balance, number of properties, WA remaining terms (in years) and WA LTV (in %),

> tables showing number of contracts or properties and mortgage amounts per remaining terms, current loan to value, total balance by property, interest rate type, distribution by W&P property region, property type, and arrears.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Although there is no mandatory reporting requirement, both of the issuers have committed to provide detailed and regular disclosure. The issuers are regulated Swiss financial institutions, which are subject to regulation, supervision and examination by the Swiss banking regulator (FINMA). The issuers are responsible for the monthly pool monitoring and Asset Coverage, Interest Coverage and Amortisation Test calculations. The results are checked and verified by an independent asset monitor who immediately advises the trustee upon their breach. The cover pools themselves are audited by independent professional auditors at regular intervals.

In addition, rating agencies are involved in the programme and re-affirm the ratings of the program upon a pre-defined issuance volume. They also monitor the amount of over-collateralisation required to maintain the triple-A ratings.

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

Upon transfer for security purposes of the mortgage loans and the related mortgage certificates, each of the guarantors (Credit Suisse Hypotheken AG and UBS Hypotheken AG) becomes the legal holder of the mortgage loans as well as the legal owner of the mortgage certificates.

In an insolvency scenario over the issuers Credit Suisse or UBS, the mortgage notes and the related mortgage certificates would not form part of Credit Suisse or UBS's estate. Accordingly, the asset cover pool may be managed and enforced by the guarantors independently from the corporate insolvency proceedings of Credit Suisse or UBS AG.

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

> Failure to pay any interest or principal amount when due;

> Bankruptcy proceedings being ordered by a court or authority against the issuer;

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

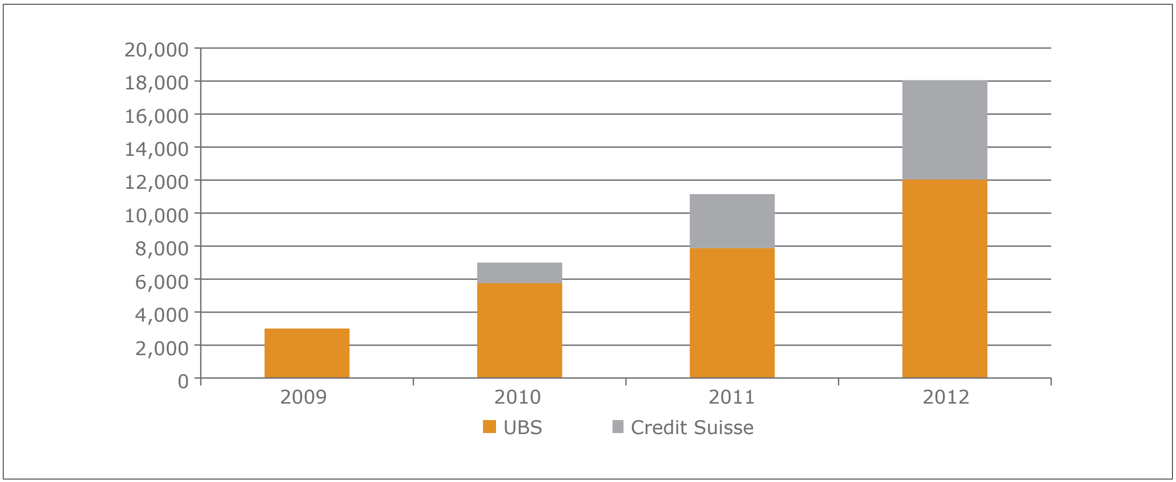
An issuer event of default would not accelerate payments to covered bondholders, but would allow the trustee to start proceedings against the issuer or the guarantor.

The second event of default is the guarantor event of default. This would arise after an issuer event of default if the guarantor failed to make any payments when due, an amortisation test failed or the guarantor was declared bankrupt. A guarantor event of default would cause the acceleration of payments to covered bondholders and their early redemption at the amount relevant to that particular covered bonds series.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

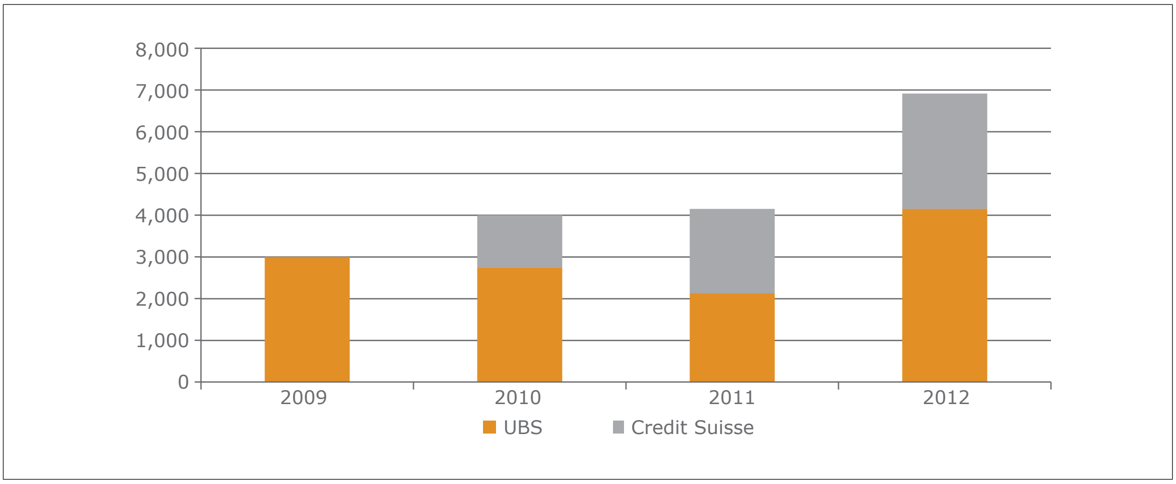
Swiss general-law based covered bonds have a 20% risk-weighting under the CRD Standard Approach. They fall under Liquidity Category III (structured covered bonds) of the ECB eligible assets criteria.

> Figure 1: Covered Bonds Outstanding 2009-2012, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2009-2012, EUR m



Source: EMF/ECBC

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/92/Credit_Suisse_CB and http://www.ecbc.eu/framework/78/UBS_CB

3.35 TURKEY

By Fritz Engelhard, Barclays Capital, Batuhan Tufan, Garanti Bank
and Ozlem Gokceimam, Garanti Bank

I. FRAMEWORK

In Turkey, the legal basis for Turkish Covered Bonds is the by-law published by the Capital Markets Board (CMB) on 4 August 2007 (Serial: III, No: 33, Mortgage Covered Bonds).

Turkish Covered Bonds are defined as "*İpotek Teminatlı Menkul Kıymetler (İTMK)*" or "Turkish mortgage covered bonds" and are trademarked by the legislation.

The İTMK by-law is part of a series of legislations, which follow the enactment of "The Housing Finance Law (No: 5582)" by the Parliament, which includes basic definitions and amendments to certain laws, aimed at establishing a healthy and functioning housing finance system on 6 March 2007.

II. STRUCTURE OF THE ISSUER

Banks defined in Article 3 of the Banking Law (No: 5411 dated 19/10/2005), as well as mortgage finance companies, are allowed to issue İTMK. The authorisation to issue İTMK is subject to the issuance of a licence by the Capital Markets Board, which can only be achievable following the fulfilment of certain conditions. Banks and mortgage finance companies who wish to issue İTMK must provide "the office, technical facilities and organisational structure" in addition to "a risk management system that will monitor the risk that may rise due to the issuance of İTMK".

Further, if the issuer is a bank issuer, the consent of the Banking Regulatory and Supervision Agency (BRSA) is also a pre-requisite.

Provided the above conditions are met together with supporting evidence, a licence to issue İTMK may be granted.

İTMK bonds are debt securities, which are general obligations of the issuer and secured by cover assets. The cover assets are held on the balance sheet of the issuer and a subsequent transfer of assets to another legal entity does not take place.

The issuer must apply to the CMB for registration of the İTMK before any issuance, public or private placement, can take place. Before such application, a cover monitor must have been appointed by the issuer.

III. COVER ASSETS

Eligible assets are residential and commercial mortgage loans. Assets originated or purchased by the issuers can be registered in the cover register if they meet the below criteria:

> Granted after the Housing Finance Law (No: 5582). If originated before, should meet the criteria defined by Article 11 of the Housing Finance Law. (Assets acquired from Housing Development Administration of Turkey are excluded from this criteria)

> All interest and principal payments have been secured by a mortgage and all obligations have been met on time.

> The property must be located in Turkey and must possess a certificate of occupancy.

> For the entire life of the loan, the real estate has to be fully insured against earthquakes, fire and any kind of natural hazard.

> The value of the property must be appraised by an officially listed real estate appraisal company and be in accordance with the by-law (Serial: VIII, No: 35, Principles Regarding Appraisal Companies)

Loans that meet the above criteria may be recorded in the cover pool up to 75% of their appraised value for residential mortgage loans and up to 50% of their appraised value for commercial mortgages.

Up to 15% of the net present value of the cover pool may comprise of substitute collateral which are cash, short term debt instruments issued by the Central Bank of Turkey, public debt instruments (domestic and foreign), securities issued under treasury reimbursement guarantee (as defined in Law No: 4749 dated 28 March 2002), securities issued or guaranteed by governments or central banks of OECD countries, or any other assets that may be approved by CMB.

Derivative instruments that are publicly traded or transacted with a bank, an insurance company or central clearing agency which are rated at least investment grade by rating agencies, can be included in the cover pool up to 15% of its net present value.

IV. ASSET - LIABILITY MANAGEMENT

The issuer is expected to perform a risk management system that will measure, analyse and devise risk policies against risks such as credit risk, interest rate risk, exchange rate risk, liquidity risk, market risk as well as operational risk and counterparty risk. Further, it has to involve certain written guidelines to reduce the before mentioned risks and adapt to changing market dynamics. It should be revisited at least once a year.

In addition to the risk management system, the cover pool must also comply with certain cover matching principles. The matching principles involve:

> Nominal Value Matching: The total volume of the İTMK must be covered at all times by assets of at least the same amount. Derivative instruments are excluded from this calculation and debt instruments are included with their face value.

> Interest Revenue Matching: The interest revenue of the cover assets for one year following the calculation date must not be less than the interest expenditures of the İTMK.

> Net Present Value Matching: The net present value of the cover assets must at all times be at least 2% more than the net present value of all obligations of the İTMK.

> The issuer has to monitor the matching of the above criteria daily and has to carry out weekly stress tests that include the parallel shifting of yield curves of matching maturity and foreign currency values. The interest rate shifts for YTL denominated bonds is determined as 300 bps, whereas the same value is 150 bps for foreign currency denominated bonds. Further, to measure the effect of exchange rate risks on cash flows a 30% parallel shift is performed on the purchase rate of the relevant currency published by Central Bank of Turkey.

V. TRANSPARENCY

According to the "Capital Market Law - Special Cases of Public Disclosure Article 16/A" – For the protection of small shareholders and the enlightenment of the public, the Board shall adopt regulations with respect to:

> The collection of share certificates;

> Requirements for proxy voting in general assemblies;

> Share certificate transfers;

> Capital increases, mergers and transfers resulting in significant changes in the share distribution of the company; and

> Notice to shareholders at times of significant events and developments affecting the value of securities and the furtherance of control of the capital and management of publicly held Joint Stock Companies.

Members of board of directors, general managers and their deputies, and shareholders holding 10% or more of the capital of publicly held joint stock corporations shall provide the Board and relevant exchanges and other organised markets such information relating to their shares in those corporations as the Board may require for the purpose of disclosure.

The Public Disclosure Platform (PDP) is an electronic system through which electronically signed notifications required by the capital markets and ISE regulations are publicly disclosed. In addition to ISE companies and ETFs, ISE member intermediary institutions may submit notifications to PDP. Independent audit companies, on the other hand, send the electronically signed financial statements for which independent audit is required, to the relevant company electronically in order to be announced to the public. Please see http://www.kap.gov.tr/yay/English/ek/KapHakkinda.aspx for further information.

VI. COVER MONITOR AND BANKING SUPERVISION

A cover monitor supervises the cover pool. The cover monitor is appointed by the issuer and must possess the expertise and experience necessary to fulfil all duties. A qualification as a certified auditor by the CMB suggests that the necessary expertise is provided.

The monitor has to ensure that the prescribed cover for the İTMK exists at all times and that the cover assets are recorded correctly in the cover register. Without the cover monitor's approval no assets may be added to or removed from the cover pool. The monitor also ensures that the cover matching principles are met once every 15 days and submits a summary report to the issuer.

The cover monitor is required to report any inconsistencies in the cover register or failures in matching principles directly to the CMB.

She/he is also authorised to conduct a discretionary review of the cover assets, including substitute assets as well as the derivative instruments in place. Further, the cover monitor can also check the land registries of the mortgages and request any other information that may be necessary for the cover monitor's review.

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

A cover register held by the issuer permits the identification and segregation of the cover assets. The collateral backing the İTMK is to be registered in book and/or in electronic form.

In case the issuer fails to meet the standards to be an issuer, the CMB simultaneously appoints another authorised bank or mortgage finance corporation, cover monitor or another audit firm as the manager to pursue the best interests of the İTMK holders. Following the loss of the issuer status, the right to actively manage the cover assets, including selling and buying of assets, is transferred to the manager automatically.

Until the İTMK are completely redeemed, cover assets cannot be sequestered, including collection of public receivables, cannot be subject to injunctive decisions of courts and cannot be included in the bankruptcy estate of the issuer.

The manager may transfer all or a part of the assets recorded in the cover register to another issuer that meets the İTMK issuer criteria. Following such transfer, the ownership of the cover assets is also passed on to the new issuer who can merge the newly acquired assets with its existing cover assets. The new issuer also automatically becomes the beneficiary of any excess cash flows from the cover assets.

If the cover assets cannot be transferred to another issuer or if the cash flows from the cover assets do not suffice, the manager can allocate the residual cash to İTMK holders according to their respective shares and further request from the CMB that the İTMK be early redeemed. Should the collateral not suffice to cover all outstanding İTMK plus interest, the İTMK holders rank pari-passu with unsecured debtors of the issuer.

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

İTMK comply with the requirements of Art. 52 par. 4 UCITS Directive as well as with those of the Capital Requirements Directive (CRD), Annex VI, Part 1, Paragraph 68 a) to f). Therefore, they may qualify for a beneficial treatment under the CRD.

The EU opened accession negotiations with Turkey on 3 October 2005. As a candidate for EU membership, Turkey will be obliged to be compliant with EU Directives in case of full membership. Thus, in recent years Turkish authorities were strongly aligning banking regulations to EU standards. The revised Accession Partnership of the EU with the Republic of Turkey from 18 February 2008 foresees that Turkey adapts its regulations to the CRD. The EU progress report on Turkey, published in November 2008, states that "further efforts are needed to continue alignment with the new capital requirements for credit institutions and investment firms".

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/50/Turkish_Covered_Bonds

3.36 UNITED KINGDOM

By Jussi Harju, Barclays and John Millward, HSBC

The UK covered bond market has been established since 2003, initially based on general English law structured finance principles prior to the introduction of a dedicated covered bond regulatory framework by HM Treasury in March 2008 (the Regulated Covered Bonds Regulations 2008 (the "Regulations")). The Regulations overlaid the existing general law and contractual structures, providing the necessary underpinning for UCITS Article 52(4) compliance and thereby provided the UK structure with benefits including higher investment limits and higher investment thresholds for insurance companies. All UK Regulated covered bonds also comply with the definition of covered bonds set out in Directive 2006/48/EC (Banking Consolidation Directive, or "BCD") thereby qualifying for lower risk-weightings. The Regulations were further amended in November 2011 to further promote the "transparency of UK covered bonds and creating a more prescriptive regulatory framework"[1]. The amendments became effective for Regulated programmes from 1 January 2013.

Regulated covered bonds are subject to special public supervision by the Financial Conduct Authority (FCA) as Special Public Supervisor, whose stated aims are to ensure a robust regulated covered bond market in the UK, and to ensure that quality is maintained to preserve investor confidence in the UK regulated covered bond market's reputation. The FCA has a wide range of enforcement powers under the Regulations, including the power to issue directions, de-register issuers or fine persons for any breaches of the requirements under the Regulations.

I. FRAMEWORK

Under the Regulations, in order to attain "regulated" status there are two general sets of requirements the issuers need to comply with – those relating to issuers and those relating to the covered bonds. Issuers are permitted (but are not required) to submit their covered bond programmes to the FCA for recognition. Those issuers and covered bonds that meet all of the criteria set out in the Regulations and are approved by the FCA are added to the register of Regulated Covered Bonds maintained by the FCA[2]. The Regulations only apply to those covered bonds which have been admitted to the register.

Most elements of the Regulated covered bond structure are governed by contract, with the Regulations providing an overarching legislative and supervisory framework without prescribing the complete design and contractual arrangements for the product. The Regulations do, however, prescribe certain key structural principles and requirements, including the requirements that assets must always remain capable of covering claims attaching to covered bonds at all times, and priority of claims against the cover pool in a winding up scenario. The FCA also has a veto over material amendments to the contracts, broad powers to enforce its provisions and conducts its own rigorous ongoing review of regulated programmes.

II. STRUCTURE OF THE ISSUER

The Regulations require the issuer to be a credit institution authorised in the UK to carry out regulated activities, such as deposit-taking. It must also have a registered office in the UK and meet certain additional criteria set out by the FCA.

Regulated covered bonds are direct, unconditional obligations of the issuer; however, investors also have a priority claim over a pool of cover assets in the event of the insolvency or default by the issuer. The Regulations require all cover assets (including any substitution assets) to be segregated from the insolvency estate

1 All UK Regulated Covered Bond key documents are available at the following link: http://www.fca.org.uk/firms/systems-reporting/register/use/other-registers/rcb-key-documents
2 The register may be found at http://www.fca.org.uk/firms/systems-reporting/register/use/other-registers/rcb-register

of the issuer by being sold to a special purpose entity (referred to in the Regulations as the "owner"), which guarantees the issuer's obligations under the bonds and provides security over the cover assets to a security trustee on behalf of the investors. All transactions to date have used a limited liability partnership (LLP) for this purpose, with the transfer effected via equitable assignment. The purchase price paid by the LLP for the cover assets is either cash (funded by an inter-company loan from the issuer) or a partnership interest in the LLP.

If the guarantee is activated, the LLP will use the cash flows from the cover pool to service the covered bonds. If these cash flows are insufficient, or within a certain timeframe of the legal final maturity of the bonds, the LLP is permitted to sell cover assets, within certain defined parameters and subject to meeting certain tests to ensure equality of treatment of bondholders.

III. COVER ASSETS

The Regulations broadly allow the following asset types:

> Assets which are listed in paragraph 68 of Annex VI of the BCD, subject to the following restrictions:
  > Exposures to credit institutions with ratings below Credit Quality Step 1 (AA-) as set out in the BCD are not permitted; and
  > Securitisations are not permitted.
> Certain assets which are not permitted under the BCD - namely loans to registered social landlords and loans to public-private partnerships (and loans to providers of finance to such companies, and subject in each case to certain restrictions)
> Liquid or "substitution" assets up to the prescribed limit (10% in most cases to date).

Issuers are required to designate programmes as either "single asset type" or "mixed asset type". Mixed asset type programmes are allowed to include any of the assets set out above, whereas single asset type programmes would be required to select either residential mortgages, commercial mortgages, or public sector loans (including social housing and PPP loans, which are not BCD eligible), in each case as defined in the BCD.

The Regulations include a narrow definition of liquid or "substitution" assets, which are defined as UK government bonds (or other government bonds which comply with the requirements set out in paragraph 68(c) of Annex VI to the BCD) or deposits in GBP or another specified currency held with the issuer or with a credit institution which comply with the requirements set out in paragraph 68(c) of Annex VI to the BCD.

Cover assets must be situated in EEA states, Switzerland, the US, Japan, Canada, Australia, New Zealand, the Channel Islands or the Isle of Man. If an issuer includes non-UK assets in its cover pool, it must get confirmation that the laws of the relevant jurisdiction would not adversely affect the rights of the LLP or the security trustee.

The Regulations require cover assets to be of high quality, and the FCA is permitted to reject any application for regulated status if it believes that the quality of the proposed assets will be detrimental to the interests of investors in Regulated covered bonds or the good reputation of the Regulated covered bonds sector in the United Kingdom.

In all of the programmes that have been registered to date, the cover pools consist of assets with narrower eligibility criteria than those allowed under the Regulations, and comprise only UK residential mortgages and the substitution assets described above.

IV. VALUATION AND LTV CRITERIA

The properties securing the mortgage loans are valued using UK mortgage market accepted practice. A surveyor is often used, although other methods (such as automated valuation models) are also accepted. Residential property values are indexed to either the Halifax or Nationwide real estate price index, each of which reports quarterly on a region-by-region basis. Price decreases are fully reflected in the revaluation, while in the case of price increases a 15% haircut is applied.

The LTV limit for mortgages varies across the different programmes (see Figure 1), but in all existing programmes it is below the 80% level for residential mortgages required under the BCD and the Regulations. Loans with LTV above this limit may be included in the pool, but the amount of the loan which exceeds the limit is excluded from the Asset Coverage Test (ACT). Loans which are in arrears are either repurchased by the issuer or subject to additional haircuts (see Figure 1).

V. ASSET – LIABILITY MANAGEMENT

For UK regulated programmes, over-collateralisation (OC) levels are determined according to the higher of: (i) the regulatory minimum amount specified in the Regulations of 8% on a nominal basis, (ii) contractual minimum amounts specified in the legal agreements, (iii) requirements imposed by the FCA, and (iv) amounts required to pass the programme's ACT (in particular as required to support the given rating level from the relevant rating agencies). However, in many programmes, the contractual minimum amounts specified are already in excess of this regulatory minimum requirement, and in any case the OC required by the rating agencies and/or FCA are significantly higher.

A key principle of the Regulations is that they require the cover pool to be capable of covering all claims attaching to the bonds at all times. In addition to the amounts required either under the regulatory minimum or under the contractual requirements, the minimum OC level for any programme is also considered by the FCA on a case-by-case basis, taking into account the quality of the cover assets, risk-mitigation measures (such as swaps and downgrade triggers) and asset-liability mismatches. The FCA has the power to require the issuer to add further assets to its cover pool if it deems the collateral to be insufficient.

The principal contractual requirement under UK structures is the presence of a dynamic ACT which must be carried out on a monthly basis to ensure that minimum OC requirements are satisfied. The ACT requires the discounted value of the cover pool (after applying the haircuts listed below) to be equal to or exceed the principal amount outstanding of covered bonds. The following haircuts are applied:

- The adjusted value of the mortgage pool is calculated by taking the lower of: (i) balance of mortgages up to the indexed LTV limit specified in the programme documents, and (ii) the asset percentage multiplied by the balance of mortgages.[3] Performing mortgages get credit 60-75% while for non-performing mortgages (i.e. >3m in arrears) this is 0-40%, depending on the programme.
- Any cash or substitution assets are also included.
- Additional haircuts are applied to mitigate set-off risk, redraw risk on flexible mortgages (if appropriate), and potential negative carry.

The asset percentage is determined on an on-going basis by the rating agencies and is subject to a maximum as set out in the programme documents (which corresponds to the minimum contractual requirement, figure 1).

The issuer is required to rectify any breach of the ACT within a specified timeframe by transferring additional cover assets to the LLP. If the breach is not rectified within the allowed remedy period, the trustee will serve a notice to pay on the LLP (see Section VIII below). The issuer may also become liable to enforcement action by the FCA.

3 For example: Let us assume a cover pool which contains two loans. Each loan has a principal balance of GBP 80 and is secured by a property worth GBP 100. If the ACT applies an LTV cap of 75% and an asset percentage of 90%, the issuer will get credit for GBP 144 of loans: applying the LTV cap would allow GBP 150 (maximum 75% LTV for each loan); but the asset percentage allows a lower amount (GBP 160 x 90% = GBP 144) and therefore takes precedence.

An amortisation test is run on each calculation date after the delivery of a notice to pay (see Section VIII below), which is designed to ensure that the cover pool will be sufficient to make payments under the covered bonds as required under the guarantee. The amortisation test is similar to the ACT, but more simply tests whether the principal balance of mortgages is sufficient to make payments in full on covered bonds, taking into account negative carry. If the test is failed, the covered bonds will accelerate against the LLP.

Most UK covered bond transactions currently in the market have a soft-bullet maturity. Following the service of a notice to pay, the legal final maturity may be extended, typically by 12 months, in order to allow the realisation of the cover assets. It is important to note that the issuer does not have the option to extend the bond's maturity; failure by the issuer to repay the bond in full on the scheduled maturity date would result in an event of default.

Certain programmes include a hard bullet option, whereby a "pre-maturity test" is designed to ensure that the LLP has sufficient cash available to repay the bonds, in full, on the original maturity date in the event of the issuer's insolvency. If, in a specified period before a maturity date (6-12 months, depending on the issuer and the rating agency), the issuer's ratings fall below certain specified triggers (typically A-1+ / P-1 / F1+), the pre-maturity test requires the LLP to cash-collateralise (either via cash contributions from the issuer or by selling cover pool assets) its potential obligations under the guarantee.

All Regulated covered bond programmes include a number of other safeguards. In particular, there are minimum rating requirements for the various third parties that support the transaction, including the swap counterparties and bank account providers, and an independent asset monitor is required to undertake an audit of the cash manager's calculations on a regular basis. Furthermore, if the issuer's short-term ratings are below A-1+ / P-1 / F1+, the LLP is required to establish and maintain (from the asset cash flows), a reserve fund which is the higher of (i) the next three months interest payments on a rolling basis, and (ii) the next following interest payment, together with the relevant amount of senior costs and GBP 600,000 (as required under the UK's Enterprise Act). This amount is retained in a SPV's bank account.

VI. TRANSPARENCY

UK regulated covered bond programmes benefit from extremely detailed investor reporting conventions in comparison to other jurisdictions. The market has conformed to a relatively high standard of reporting since inception, but in addition the FCA requires detailed reporting to be provided by Regulated issuers in its capacity as special public supervisor.

Similarly, transparency is to a large extent driven by the eligibility criteria in the Bank of England (BoE) Sterling market operations, under which (among other things) issuers must publish transaction documentation, provide homogenised transaction summaries and investor reports, and publish loan level data.

FCA reporting requirements, which were updated in December 2011 and became effective in January 2013, are closely aligned with the BoE criteria but also include certain additional items not included in the BoE criteria. Since the introduction of the updated amendments, all Regulated issuers have expanded their investor reporting templates to take account of both sets of rules.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

An applicant under the Regulations must be a credit institution authorised in the UK to carry out regulated activities, such as deposit-taking. Issuers must satisfy the FCA that their programmes comply with the criteria set out in the Regulations and provide, among other things:

> Details on the quality of cover assets and the ability of the assets on the issuers balance sheet to satisfy substitution requirements;

> Details concerning the programme structure, such as the cover pool eligibility criteria, the formulae used to calculate compliance with minimum OC requirements, ability to meet payments on a timely basis and ratings triggers;

> Details concerning asset and liability management, audit and controls, risk management and governance framework;

> Details on the proficiency of cash management and servicing functions;

> Detailed analysis on the ability of the assets and the mitigants within the programme structure to address inherent interest rate, currency, asset and liability mismatch and market value risks;

> Arrangements for the replacement of key counterparties; and

> Independent legal and audit opinions on the compliance of the issuer and programme with the Regulations.

The issuer is responsible for monthly cover pool monitoring. The FSA must be notified by the issuer of any breaches of the ACT, and may also require the issuer to provide such additional information about the cover pool as it considers fit. All existing programmes have at least two internationally recognised rating agencies who will also undertake detailed reviews both on a condition precedent to each issuance, and thereafter on at least a quarterly basis as part of ongoing transaction surveillance. The rating agencies may revise the asset percentage as part of these review processes, either due to variations in asset quality or embedded transaction risk factors, or due to periodic rating criteria change.

All programmes already involve an independent third party asset monitor within the existing contractual arrangements (in all cases, this role is fulfilled by an independent audit firm), who would perform various functions within the transaction including an annual review of the ACT calculation. All programmes (and the FCA) also require periodic audit procedures to be undertaken with respect to the asset pool, which in most (but not all) programmes is performed by the same audit firm.

Since 1 January 2013, the Regulations have been updated to include a specific requirement for regulated programmes to be subject to scrutiny from an independent "Asset Pool Monitor" which will be conveyed with certain powers to inspect books and records associated with the relevant programme, must conduct a biannual inspection of the issuer's compliance with the Regulations and must report to the FCA on an annual basis (or sooner if the issuer is found to be failing to comply with its duties). It is expected that the UK programmes will be updated through the course of the next 12 months to reflect this new requirement.

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

The Regulations require all cover assets (including any substitution assets) to be segregated from the insolvency estate of the issuer by being transferred to a special purpose entity (referred to as the "owner" in the Regulations), which guarantees the issuer's obligations under the bonds. All transactions to date have used an LLP for this purpose.

The Regulations require that the cover assets be recorded on a register maintained by or on behalf of the issuer and the LLP. The register must be available for inspection by the FCA. The issuer is responsible for ensuring that all cover assets meet the relevant eligibility criteria set out in the Regulations and, if applicable, any additional criteria set out in the programme documents.

The LLP becomes obliged to pay the covered bondholders under the guarantee upon delivery by the bond trustee of a notice to pay following the occurrence of an issuer event of default or other trigger event. The events which can trigger a notice to pay typically include:

- Failure by the issuer or any group guarantors to pay any interest or principal on the covered bonds when due;
- Bankruptcy or similar proceedings involving the issuer or any group guarantors;
- Failure to rectify any breach of the asset coverage test (in most cases); and
- Failure to rectify any breach of the pre-maturity test (if applicable).

To the extent that an issuer event of default has occurred, the bond trustee may commence proceedings against the issuer and any group guarantors on an unsecured basis on behalf of the covered bondholders. The delivery of a notice to pay does not however accelerate payments to noteholders, and the LLP will continue to make payments of interest and principal on the covered bonds on their originally scheduled payment dates (provided that an LLP acceleration event (as described below) has not occurred).

LLP acceleration events typically include:

- The LLP fails to pay any interest or principal when due under the guarantee;
- Bankruptcy or similar proceedings are commenced involving the LLP; and
- After delivery of a notice to pay, the LLP breaches the "amortisation test".

The occurrence of an LLP acceleration event causes the acceleration of payments by the LLP to covered bond-holders and the redemption of the bonds at the relevant early redemption amount.

The LLP is reliant on the proceeds derived from the cover assets to make payments under the guarantee. Under the Regulations, in a winding up scenario, no claims against the cover assets can rank ahead of the claims of the Regulated covered bondholders. If the proceeds from the cover pool are insufficient to meet the obligations to bondholders in full, investors will continue to have an unsecured claim against the issuer (and any group guarantors) for the shortfall.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The list of eligible assets under the Regulations is in some respects narrower than that set out in the CRD (particularly for single asset type programmes as described above). To date, all existing Regulated covered bonds are contractually restricted to containing only residential mortgage assets (as well as substitution assets up to the prescribed limit), meaning they are BCD compliant and therefore benefit from the same preferential treatment as covered bonds from other EU jurisdictions. However, certain assets which are excluded from the BCD – such as loans to UK housing associations – are technically permitted in the cover pool under the Regulations, and so it is possible that in future programmes could be structured which do not qualify for the preferential risk weightings.

> FIGURE 1: OVERVIEW – REGULATED UK COVERED BOND PROGRAMMES

At the time of writing there are 12 regulated covered bond issuers in the United Kingdom: Abbey National (ABBEY); Barclays Bank Plc (BACR); Bank of Scotland Plc (HBOS); HSBC Bank (HSBC), Leeds Building Society (LEEDS), Lloyds TSB Bank (LLOYDS), Nationwide Building Society (NWIDE); Royal Bank of Scotland (RBS); Coventry Building Society (COVBS); Yorkshire Building Society (YBS) and Co-operative Bank (COOPWH).

	ABBEY	BACR	CLYDES	COOPWH	COVBS	HBOS	HSBC	LEEDS	LLOYDS	NWIDE	RBS	YBS
Programme volume (bn)	€ 35	€ 35	£10	£3	€ 7	€ 60	€ 25	€ 7	€ 30	€ 45	€ 15	€ 8
LTV cap	75%	75%	75%	75%	75%	60%	75%	75%	75%	75%	75%	75%
House price index	Halifax	Halifax	Nation-wide	Halifax	Nation-wide	Halifax	Halifax	Halifax	Halifax	Nation-wide	Halifax	Avg. of Halifax & Nation-wide
Maximum asset percentage	91.0%	94/0%	90.0%	93.5%	90.0%	92.5%	92.5%	93.5%	93.0%	93.0%	90.0%	92.5%
Minimum OC*	110%	106%	111%	107%	111%	108%	108%	107%	108%	108%	111%	108%
Current asset percentage	90.0%	72.8%	79.5%	77.5%	78.4%	70.0%	87.0%	77.8%	85.5%	84.5%	74.3%	81.6%
Current nominal OC	149%	155%	159%	286%	138%	151%	1070%	189%	148%	147%	160%	187%
Credit for loans in ar-rears (>3 months)	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	No credit	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	LTV<75: 40% LTV>75: 25%	<3M: 75%, >3M: 40%	LTV<75: 40% LTV>75: 25%
Can issue hard bullets? **	Yes	Yes	Yes	Yes	No	Yes	Yes	No	Yes	Yes	Yes	No
Asset monitor	Deloitte	PWC	E&Y	PWC	E&Y	KPMG	KPMG	Deloitte	PWC	PWC	Deloitte	KPMG

Source: Barclays Research, transaction documents.

* OC = Over-collateralisation, minimum OC calculated as 1/maximum asset percentage.

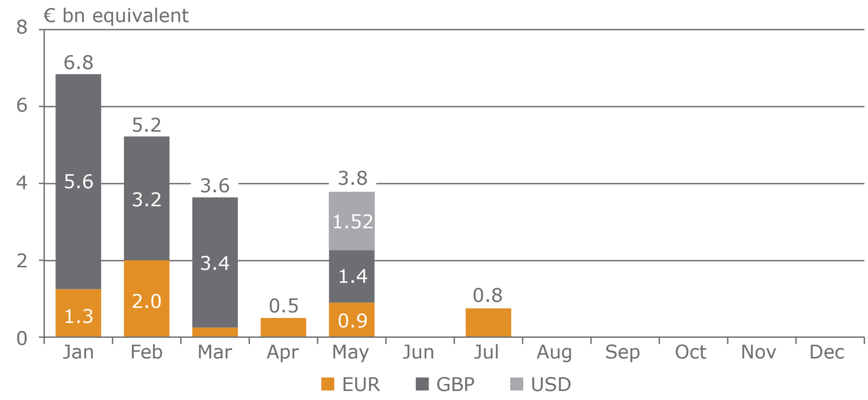
** Hard-bullets possible only if pre-maturity test is in place and passed / soft-bullets issued with 12-months extension.

X. ADDITIONAL INFORMATION

The current outstanding volume of regulated publicly placed fixed-rate benchmark covered bonds and respective taps amounts to EUR 106 bn (equivalent). Gross supply in 2011 was EUR 30.9 bn, versus modest redemptions of EUR 8.3 bn, increasing the total outstanding volume to EUR 101 bn at the end of 2011. In 2012 the UK market grew by circa EUR 10 bn following EUR 14.4 bn gross supply and very low redemptions of EUR 4.5 bn. However, the market has not seen any new issuance since May 2012 and near term supply expectations at the time of writing are limited.

In 2011, the UK covered bond market opened up for benchmark GBP-denominated covered bonds. In 2004, 2006 and 2010 there were smaller issuances but GBP-issuance in meaningful sizes did not occur until 2011. A total of GBP 6.6 bn of GBP-denominated covered bonds were issued, representing 25% of 2011 issuance volume, with the majority happening in the first four months of the year. This positive trend continued at the start of 2012 but the public issuance activity came to a halt in May. UK banks and building societies issued a total of GBP 11.3 bn of GBP covered bonds in 2012, of which GBP 6 bn were issued in fixed rate format while GBP 5.3 bn were issued in floating rate format. Since May the only issuance activity were the occasional taps in July 2012.

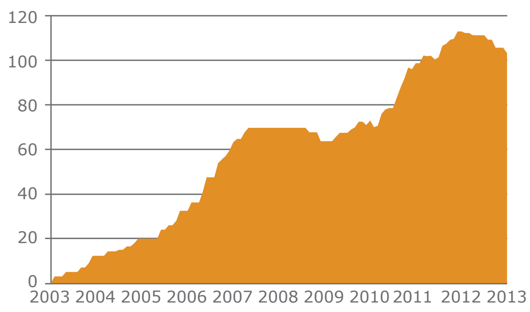
> Figure 2: Monthly supply of UK covered bonds in 2012 (fixed and floating rate)



Source: Barclays Research

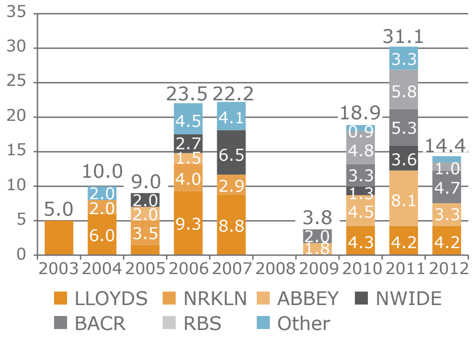
Figure 3 and 4 show the development of total outstanding of regulated fixed-rate benchmark UK covered bonds and annual supply of UK covered bonds per currency. Figures 5 and 6 show the market share (as measured by covered bonds outstanding) per issuer and the currency distribution for outstanding issuances.

> Figure 3: Development of outstanding volume (fixed rate benchmark issuances), EUR bn



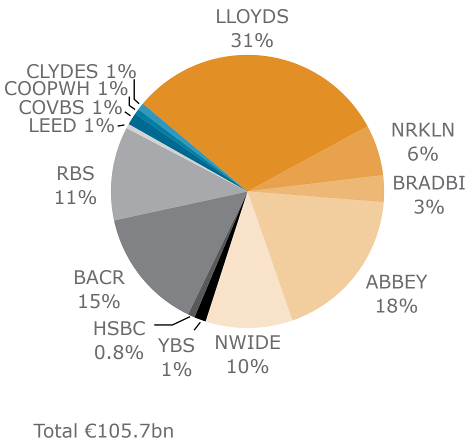
Source: Barclays Research

> Figure 4: Annual supply per issuer (fixed rate benchmark issuances), EUR bn



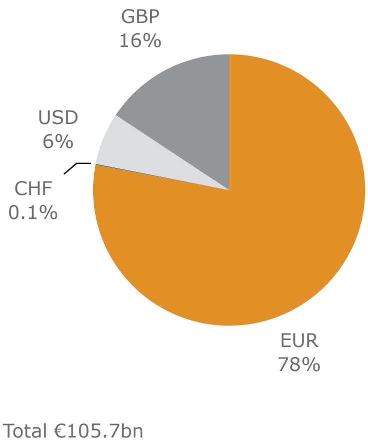
Source: Barclays Research

> Figure 5: Market share of outstanding, May 2013 (fixed rate benchmark issuances)



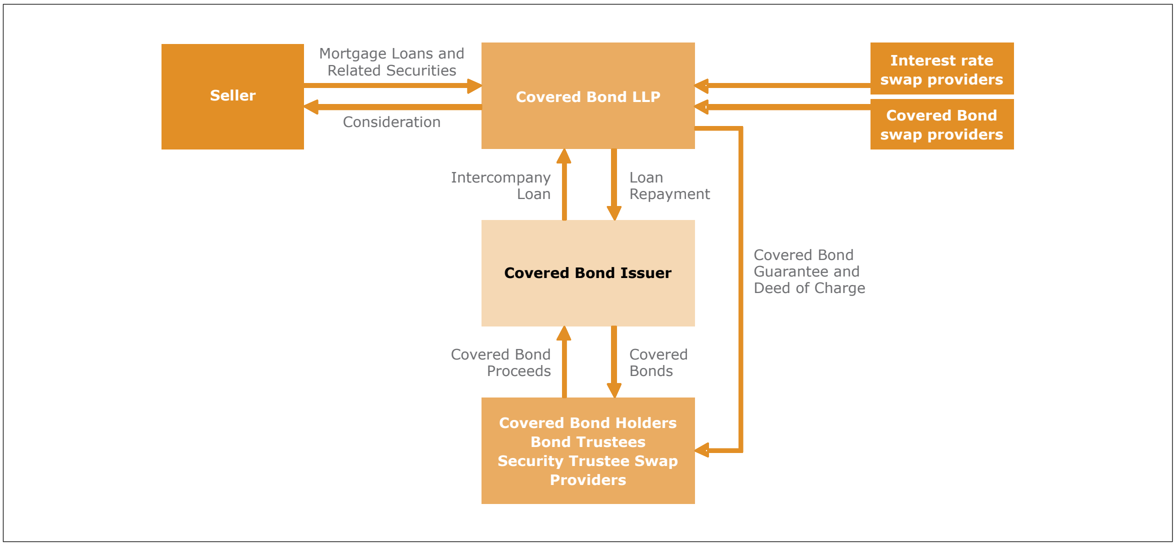
Source: Barclays Research

> Figure 6: Outstanding fixed rate benchmark issuances by currency, May 2013



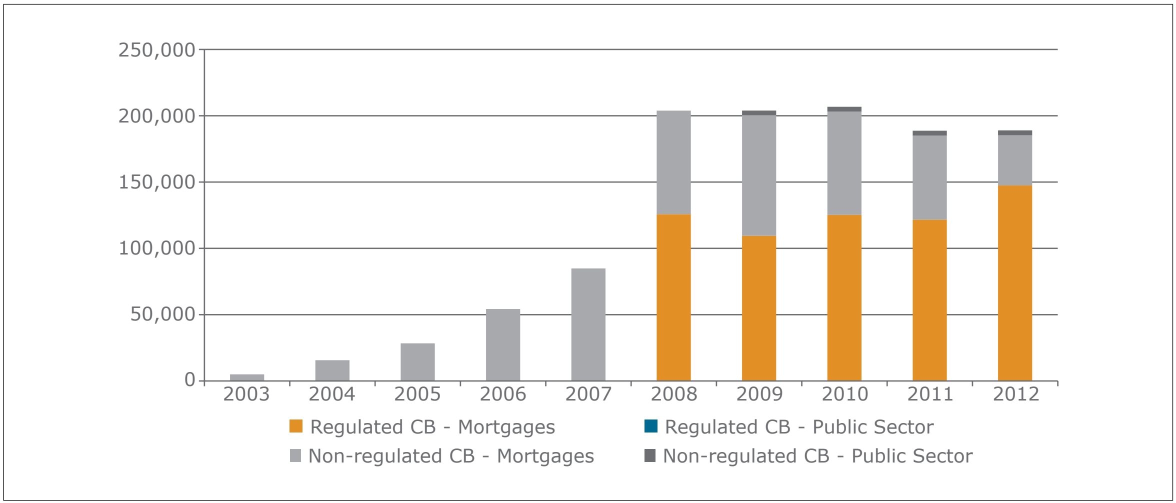
Source: Barclays Research

> FIGURE 7: GENERIC UK COVERED BOND PROGRAMME STRUCTURE



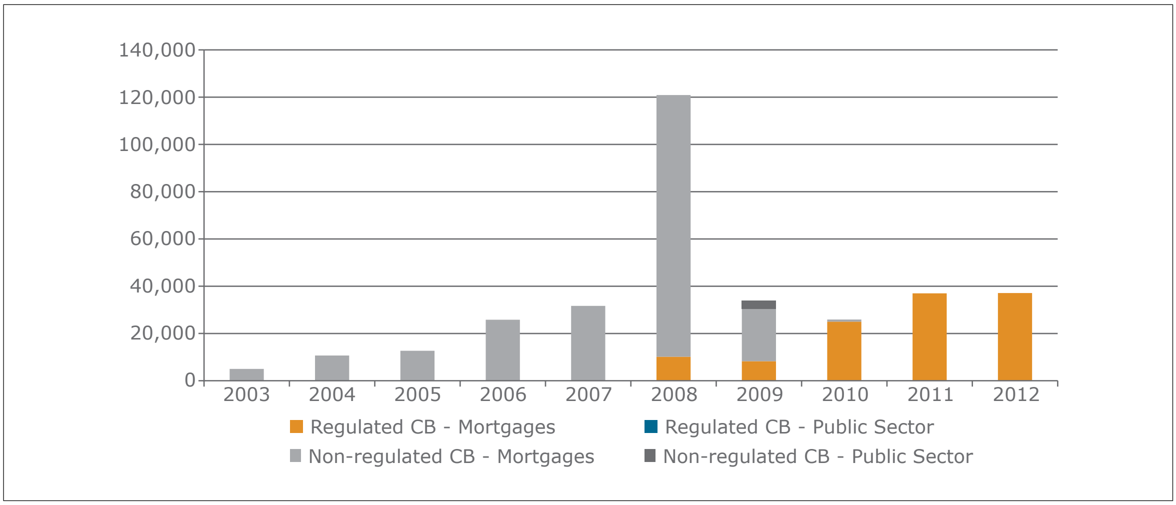
Source: Barclays Research

> Figure 8: Covered Bonds Outstanding, 2003-2012, EUR m



Source: EMF/ECBC. Please note that this data includes private placements, floating rate covered bonds and self-retained issuances that may have been used to access central bank liquidity.

> Figure 9: Covered Bonds Issuance, 2003-2012, EUR m



Source: EMF/ECBC. Please note that this data includes private placements, floating rate covered bonds and self-retained issuances that may have been used to access central bank liquidity

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/52/Regulated_Covered_Bonds_-_RCB, http://ecbc.eu/framework/104/Unregulated_Covered_Bonds

3.37 UNITED STATES

By Sabine Winkler, Credit Suisse Securities (Europe) Limited

I. FRAMEWORK[1]

US covered bond legislation: review & outlook

Covered bonds are a common bank funding instrument in several countries. Although they are not prohibited in the US, there are few US covered bonds. The market is on hold since June 2007. As a robust market may bring additional private capital into the US lending market, policymakers are considering covered bonds as an alternative. Although legislation may facilitate the development of a domestic market, the US does not yet have a statutory framework for the product. There have been several attempts to introduce covered bonds in the US, but the product has been stymied by the absence of legislation, the resolution of broader issues associated with the securitisation and housing finance reform, and the existing rights of the Federal Deposit Insurance Corporation (FDIC) in the resolution of a US lender, which pose risk to and create uncertainty for US covered bond holders, and add to the costs of the product for US lenders.

Rulemaking efforts in the US started in 2008 with the release of the FDIC Policy Statement on Covered Bonds and the US Treasury's Best Practices for Residential Covered Bonds (Best Practices Guide). The hope was that these statements would provide clarity and allay investor concerns and support prudent and incremental growth of a US covered bond market. Since their release, it has become apparent that non-legislative guidance alone is insufficient to promote the development of a robust US covered bond market. There was an active effort to introduce covered bond legislation in the US in the 112th Congress. In 2011, the House Committee on Financial Services approved H.R. 940, and S. 1835 was introduced into the Senate and referred to the Senate Committee on Banking, Housing, and Urban Affairs for consideration. Both H.R. 940 and S. 1835 were designed to establish the fundamental elements of US covered bonds.

The 112th Congress ended and the 113th Congress convened on 3 January 2013. Once a Congress adjourns at the end of its two-year cycle, bills that were introduced in the House of Representatives or the Senate or both and that did not make it through the legislative process and were not signed into law need to be reintroduced. Identical legislative text needs to be approved by both the House of Representatives and the Senate, and the final legislative text has to be signed by the President in order to become law. It is relatively common that bills are reintroduced in different Congresses before action is being taken. According to the oversight plan of the Committee on Financial Services of the House of Representatives for the 113th Congress, covered bonds are on the agenda of the House of Representatives, i.e., the House Committee on Financial Services will review the potential for covered bonds as a new funding source for US lenders.

Proposed United States Covered Bond Act (112th Congress)

A In June 2011, the House Committee on Financial Services approved H.R. 940, the United States Covered Bond Act of 2011. H.R. 940 was introduced by Scott Garrett (R-NJ) and Carolyn Maloney (D-NY) in March 2011. H.R. 940 is similar to H.R. 290 introduced in 2011, and H.R. 5823 and H.R. 4884 introduced by Scott Garrett (R-NJ), Paul E. Kanjorski (D-PA) and Spencer Bachus (R-AL) in 2010, and Scott Garrett's (R-NJ) proposed changes to H.R. 4173[2], the Wall Street Reform and Consumer Protection Act of 2009, that were introduced in 2009, but that were later withdrawn at the request of Barney Frank (D-MA). H.R. 940 is more comprehensive than H.R. 2896, the Equal Treatment of Covered Bonds Act of 2009, and H.R. 6659, the Equal Treatment of Covered Bonds Act of 2008.

1 The description of the US framework is merely a summary of aspects of the (proposed) legislation. As a summary, it is not complete. For details refer to the respective (draft) legislation, regulations, statements and base prospectuses. This summary does not constitute legal advice by the author.

2 H.R. 4173 eventually became Public Law 111-203, Dodd-Frank Wall Street Reform and Consumer Protection Act.

In November 2011, S. 1835, the United States Covered Bond Act was introduced into the Senate by Kay Hagan (D-NC) and Bob Corker (R-TN). It is co-sponsored by Michael Crapo (R-ID) and Chuck Schumer (D-NY). The language of S. 1835 is close to H.R. 940. Notable differences from H.R. 940 are: an expansion of the definition of eligible issuers; for issuers that are not subject to the jurisdiction of a federal banking agency, the covered bond regulator would be the Board of Governors of the Federal Reserve System rather than the Secretary of the Treasury; a right afforded to the respective covered bond regulator and a majority of covered bond holders to replace the independent asset monitor; and the omission of tax provisions.

Both H.R. 940 and S. 1835 address some of the uncertainties restricting the acceptance of general-law-based US covered bonds, and cover the following points:

> **Issuers**: In accordance with H.R. 940, eligible issuers would be insured depository institutions (IDIs), savings and loan holding companies, bank holding companies, non-bank financial companies and their subsidiaries. In accordance with S. 1835, eligible issuers would further be brokers, dealers, insurance companies and their subsidiaries. Pooled covered bond issuance by entities sponsored by eligible issuers would be permitted. This would provide an opportunity for smaller-sized lenders to use the product. A regulator could approve existing programmes. Eligible issuers would be allowed to have more than one covered bond programme.

> **Collateral**: In accordance with H.R. 940 and S. 1835, a cover pool would be defined as a dynamic asset pool and would consist of eligible assets from a single eligible asset class, substitute assets and ancillary assets. Eligible asset classes would initially be residential mortgages, commercial mortgages, public-sector debt, auto loans or leases, student loans, credit or charge card loans and small business loans. Issuers would have to clearly mark collateral in their books and records. A loan would not qualify as an eligible asset if delinquent for more than 60 consecutive days. An asset in a cover pool that would not qualify as an eligible asset could not be taken into account in the Asset Coverage Test (ACT).

> **Supervision**: The covered bond regulator for an issuer would be the appropriate federal banking agency or, for an issuer that is not subject to the jurisdiction of such agency, the Secretary (H.R. 940) or the Board of Governors of the Federal Reserve System (S. 1835). The Secretary, in consultation with the covered bond regulators, would have to set up an oversight programme within 180 days after the enactment of the act. Covered bond programmes would require approval by the respective covered bond regulator. The Secretary would maintain a publicly available registry of approved programmes and the covered bonds drawn under them. The respective covered bond regulator could direct an issuer to cease issuing covered bonds if an approved programme is not maintained in line with the law and the oversight programme.

> **Coverage**: The Secretary, in consultation with the covered bond regulators, would define minimum OC levels for covered bonds backed by each of the eligible asset classes based on their credit, collection and interest rate risks, but not liquidity risk. To verify compliance with the OC requirement, issuers would have to perform an Asset Coverage Test (ACT). Each month, an issuer would have to submit the ACT outcome to the Secretary, the respective covered bond regulator, indenture trustee, asset monitor and bondholders. Bonds issued under an approved programme would remain special-law-based even if the OC requirement were not met. An uncured failure of the OC requirement within a set time would constitute a default on covered bonds. This regulatory minimum OC requirement would not preclude a higher one from being established by issuers under their covered bond programmes.

> **Limit**: Based on safety and soundness considerations and the financial condition of an issuer, the respective covered bond regulator would set a covered bond issuance limit as a percentage of total assets. A covered bond regulator could review this limit as often as quarterly, and if safety and soundness considerations or an issuer's financial condition have changed, increase or decrease the limit. A cut of the limit would not affect an issuer's outstanding covered bonds.

> **Monitoring**: Each issuer would have to appoint an independent asset monitor that verifies and reports at least annually to the Secretary, the respective covered bond regulator, indenture trustee and bondholders whether a pool meets the regulatory minimum OC requirement. At least monthly, issuers would have to deliver a list of the eligible and substitute assets in the pool to the independent asset monitor and indenture trustee.

> **Reporting**: In accordance with existing securities regulations, each covered bond regulator would adopt a separate scheme of registration, disclosure and reporting obligations and exemptions for offers or sales of covered bonds. Once a year, the covered bond regulators would have to submit a joint report to the Congress describing the state of the covered bond market in the US and testify on the state of this market before the House of Representatives and the Senate.

> **Borrowings**: The Comptroller General of the United States would have to conduct a study whether a separate estate should have access to loans from the Federal Reserve Banks. The Comptroller General of the United States would have to submit a report to the Senate and the House of Representatives on the results of this study not later than six months after the enactment of the US covered bond law.

> **Actions**: No court would be able to take any action to restrain or affect the resolution of a separate estate, except at the request of the respective covered bond regulator. In addition, no person, including bondholders, could bring a judicial or administrative action against the estate, except to compel the release of funds that are required to be distributed.

> **Insolvency**: There are two scenarios: default on covered bonds either before or after an issuer enters conservatorship, receivership, liquidation or bankruptcy (issuer insolvency). Issuer insolvency would not necessarily cause an acceleration of the outstanding covered bonds.

a) **Default on covered bonds before issuer insolvency**: The cover pool and the related covered bonds would be automatically transferred to a newly created separate estate.

b) **Default on covered bonds after issuer insolvency without FDIC involvement**: The cover pool and the related covered bonds would be automatically transferred to a newly created separate estate.

c) **Default on covered bonds after issuer insolvency with FDIC involvement**: The FDIC would have the right to transfer the cover pool and the related covered bonds to another eligible issuer within a one-year period. Until a transfer is made or the FDIC elects to cease further performance, the FDIC would be required to meet the issuer's obligations under the covered bonds. If the FDIC does not complete the transfer within one year, elects to cease further performance or fails to meet an issuer's obligations under the covered bonds, the cover pool and the related covered bonds would be automatically transferred to a newly created separate estate.

The transferee, whether a newly created separate estate or another eligible issuer, would become liable for the covered bonds and the related obligations of the issuer secured by the cover pool. The cover pool would be held by the transferee free and clear of any right, title, interest or claim of the issuer or any conservator, receiver, liquidating agent or bankruptcy trustee.

If a separate estate were created, investors would retain a claim against the issuer for any deficiency with respect to the covered bonds. The issuer or its conservator, receiver, liquidating agent or bankruptcy trustee would retain a residual interest in the estate. The issuer or its conservator, receiver, liquidating agent or bankruptcy trustee would be required to transfer to the estate all property of the estate that is in the possession or under the control of the issuer and may have to continue servicing the cover pool for 120 days.

The respective covered bond regulator would give the Secretary, the indenture trustee, the residual interest owner and the bondholders written notice of the creation of the separate estate. It would appoint a trustee for the separate estate and servicers or administrators for the cover pool. The servicers or administrators would actively manage the cover pool and would have to maximise its proceeds and value.

They would be allowed to dispose of assets in the cover pool, and, in order to manage timing mismatches among the assets and liabilities of the estate, to raise funds. The respective covered bond regulator would supervise the trustee and any servicer or administrator. The respective regulator would be permitted to remove or replace the trustee or any administrator or servicer and require reports from a servicer or administrator. The trustee would close the estate after it has been fully administered.

Covered Bond Policy Statement & Best Practices Guide

On 9 July 2008, the FDIC approved its Policy Statement on Covered Bonds, clarifying its position on the treatment of qualifying covered bonds in a receivership or conservatorship. On 29 July 2008, the US Treasury released its Best Practices Guide with the support of the FDIC, the Office of Thrift Supervision, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Securities and Exchange Commission. The Best Practices Guide introduces guidelines to promote the development of a standardised market for US covered bonds backed by residential mortgages.

The FDIC Policy Statement on Covered Bonds and the Best Practices Guide represented a step forward in 2008. However, it has become apparent that a US covered bond market is unlikely to be built solely on their foundation. In fact, the Best Practices Guide serves as a template for market participants, and the FDIC Policy Statement on Covered Bonds is designed to provide for relief from the temporary automatic stay of execution rule incorporated into the Federal Deposit Insurance Act (FDIA) in 2006. It is not prohibited that US lenders issue general-law-based covered bonds.

FDIC: Policy Statement on Covered Bonds

The policy statement provides guidance on the availability of expedited access to collateral in the cover pool in a receivership or conservatorship, after the FDIC decides whether to continue or to terminate the transaction. Its focus is to seek a way around the temporary automatic stay of execution rule imposed under the FDIA. Under the FDIA, the FDIC can request a stay of up to 45 days (as conservator) or 90 days (as receiver). For covered bonds structured in accordance with the FDIC Policy Statement on Covered Bonds, the stay can be shortened to ten days. The policy statement applies to bonds meeting the following criteria.

> **Features**: The policy statement applies to bonds that are non-deposit, recourse debt obligations of IDIs with a term greater than one year, and no more than 30 years, that are secured, directly or indirectly, by perfected security interests under applicable state and federal law on collateral held and owned by the IDI.

> **Limit**: The policy statement applies to covered bonds issued with the consent of an IDI's primary federal regulator. It is limited to covered bonds that comprise no more than 4% of an IDI's total liabilities after issuance.

> **Collateral**: Performing mortgages meeting the existing supervisory guidance on the underwriting of residential mortgages, on one-to-four family properties, underwritten with documented income and at the fully indexed rate are eligible. The loan-to-value (LTV) for the mortgages in the cover pool needs to be disclosed. MBS collateralised by eligible mortgages must not exceed 10% of the collateral. Substitution collateral may be cash, US Treasury and agency securities.

The policy statement must not be construed as waiving, limiting or otherwise affecting the rights or powers of the FDIC. Neither does it impose new responsibilities on the FDIC as conservator or receiver. The FDIC may consider changes to the policy statement as the US covered bond market develops. It can repeal the policy statement after 30 days' notice in the Federal Register. In this event, securities launched before repeal, but in compliance with the policy statement, will be grandfathered.

US Treasury: Best Practices Guide

The Best Practices Guide is a complement to the FDIC Policy Statement on Covered Bonds and presents a standardised model for covered bonds issued by US lenders in the absence of covered bond legislation. It outlines two structures: SPV Issuance and Direct Issuance. To be consistent with the Best Practices Guide, a covered bond programme has to meet the following criteria.

> **Issuer**: Issuers may be depository institutions and their subsidiaries, and bankruptcy-remote SPVs. Pooled issuance is possible, i.e., multiple depository institutions could use a joint SPV to pool assets. The collateral has to be owned by the depository institution. Only well-capitalised entities should issue covered bonds.

> **Features**: The maturity for covered bonds has to be greater than one year, but no more than 30 years. Covered bonds may be issued in any currency and may be registered or non-registered with the SEC. They may either be fixed or floating rate instruments.

> **Limit**: An issuer requires approval by its respective primary regulator to launch covered bonds. Covered bonds may account for no more than 4% of an issuer's total liabilities after issuance.

> **Security**: Issuers need to grant a first priority perfected security interest in the collateral for the benefit of the bondholders. Issuers have to clearly mark the collateral, liabilities and the security pledge in their books and records. Multiple series can be backed by a common cover pool.

> **Coverage**: At all times, issuers must maintain an OC of at least 5% of the outstanding principal balance of the covered bonds. When calculating OC, for each loan, up to 80% of the property's value can be taken into account. If more than 10% or 20% of the collateral is substituted in any month or quarter, respectively, issuers must disclose updated collateral information to investors.

> **Test**: Issuers need to conduct a monthly ACT. The results of the ACT and of any reviews by the asset monitor must be made available to investors. If an ACT is failed, issuers may not launch a new series while such a breach exists. If an ACT is failed, and the breach is not remedied within one month, the trustee may terminate the covered bond programme and principal and accrued interest must be paid to investors.

> **Collateral**: Performing first-lien mortgages on one-to-four family properties, meeting the existing supervisory guidance on the underwriting of residential mortgages, underwritten with documented income and at the fully indexed rate are eligible. Ineligible are negative amortisation mortgages. Mortgages over 60 days in arrears must be replaced. At the time of inclusion in the cover pool, mortgages need to have a maximum LTV of 80%. The LTV needs to be updated quarterly using a nationally recognised, regional housing price index or other comparable measurement. A single Metro Statistical Area cannot make up over 20% of the cover pool. Substitution collateral may be cash, US Treasury and agency securities.

> **Derivatives**: At issuance of a series, issuers may enter into derivative agreements for the series to hedge risks arising from any timing and currency discrepancies. Derivative agreements need to be with financially sound counterparties and the identity of those counterparties has to be disclosed to investors.

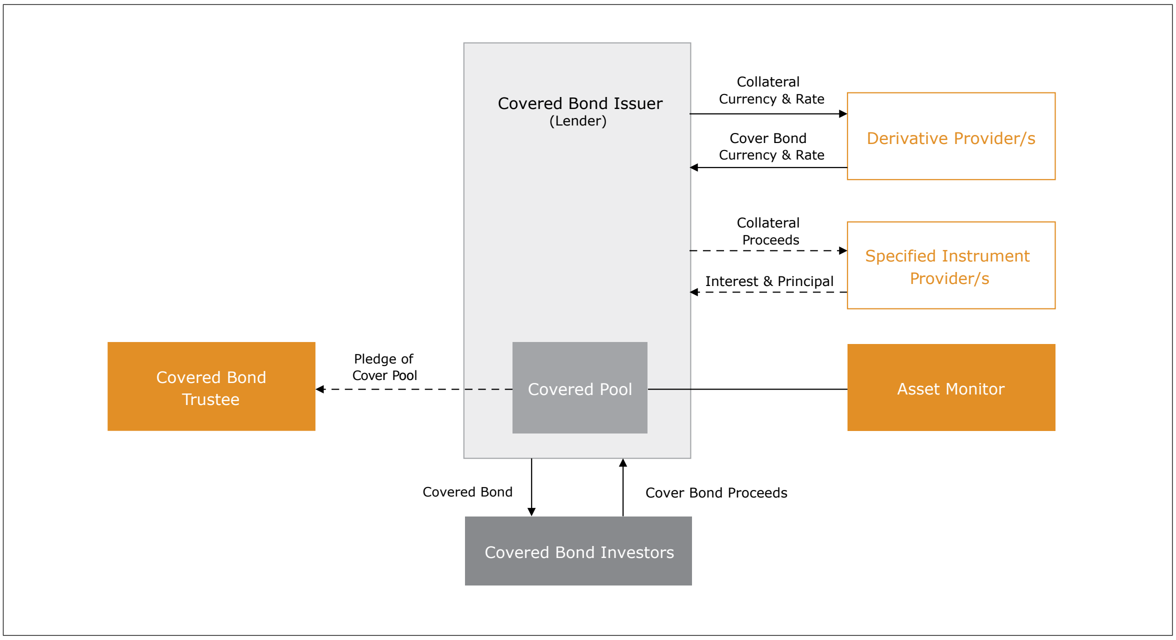
> **Investment**: At issuance of a series, issuers need to enter into a specified investment agreement for the series with financially sound counterparties. Upon issuer insolvency or repudiation by the FDIC as conservator or receiver, proceeds from the collateral must flow into the specified investment. Scheduled payments are paid out of this investment as long as the investment provider receives proceeds in an amount at least equal to the amount falling due. If the proceeds are insufficient to meet a payment, the series would become immediately due and payable (payment acceleration).

> **Disclosure**: At the time an investment decision is made, and monthly after issuance, descriptive information on the collateral must be disclosed to investors no later than 30 days after the end of each month. The depository institutions and SPV need to disclose information relating to their financial profile and other material information.

> **Monitoring**: The primary regulators monitor an issuer's controls and risk management processes. Issuers must designate an independent asset monitor and an independent trustee. An asset monitor has to determine compliance with the ACT. A trustee needs to represent bondholder interests and enforce their rights in the collateral in the event of issuer insolvency.

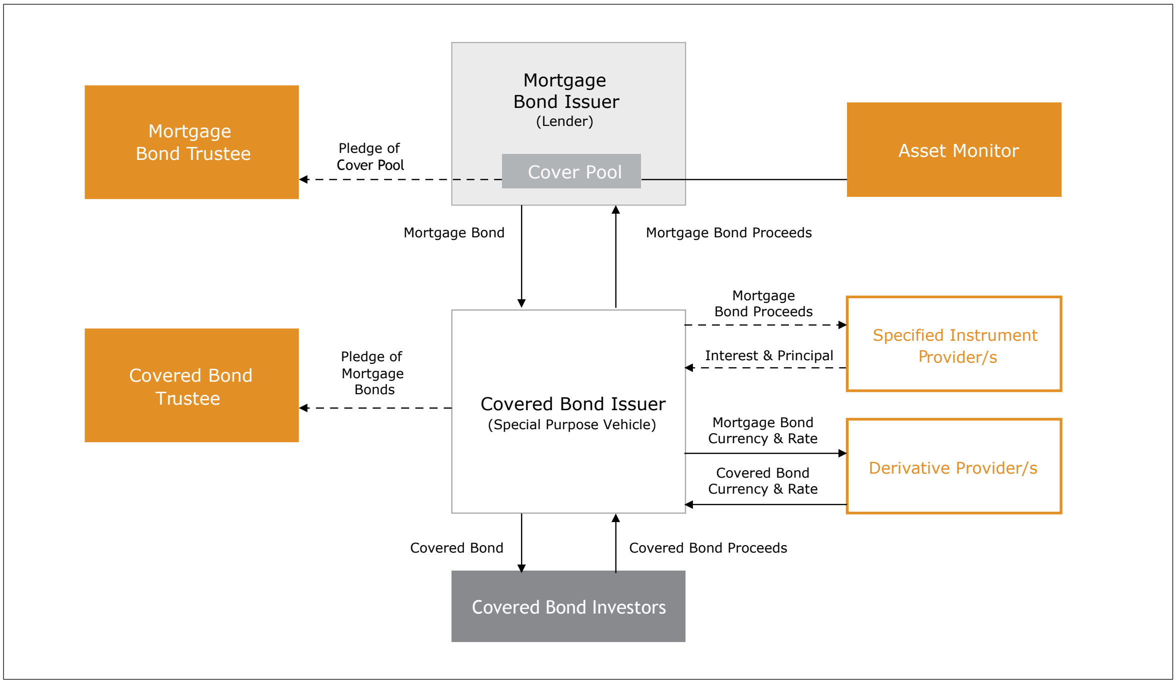
> **Insolvency**: As receiver or conservator for an IDI, the FDIC has three options in responding to a covered bond: the FDIC affirms the bond and meets the IDI's obligations under the bond; it pays off the bond in cash up to the collateral value; or it allows liquidation of the collateral to pay off the bond. The second and third options are triggered if the FDIC repudiates the bond or if default occurs. In each case, an amount equal to actual direct compensatory damages is paid in full up to the collateral value. If the collateral value exceeds the actual direct compensatory damages, the excess amount is returned to the FDIC as conservator or receiver for the IDI. If investor claims are not met (i.e., the actual direct compensatory damages exceed the collateral value), any unsatisfied claims are unsecured claims in the receivership or conservatorship. Any losses must be allocated pro rata across series backed by a common cover pool, irrespective of the maturity of the individual series.

> FIGURE 1: SIMPLIFIED DIRECT ISSUANCE



Source: Best Practices Guide, Credit Suisse

> FIGURE 2: SIMPLIFIED SPV ISSUANCE



Source: Best Practices Guide, Credit Suisse

US lenders: SPV Issuance currently in practice

In the absence of covered bond legislation, Bank of America and Washington Mutual Bank developed structures under general law. Both structures make use of SPV Issuance and operate a two-tier approach: the covered bonds are issued by special purpose vehicles, rather than by US lenders. They are secured by a related mortgage bond series launched by a lender. The mortgage bond series is backed by collateral that remains on the lender's balance sheet. This structure, by its nature, is more cumbersome, complex and costly than direct issuance (i.e., where the covered bonds are launched by a lender and the covered bond collateral remains on its balance sheet) and as the crisis intensified, became disfavoured by investors.

Importance of first priority perfected security interests

The existing programmes of Bank of America and JP Morgan Chase Bank are governed by, and construed in accordance with, the laws of the State of New York and the State of Delaware, including the Uniform Commercial Code as adopted in each of those states. Applicable to these programmes are also federal legislations, including federal securities and tax laws and the FDIA. The Uniform Commercial Code adopted by each state in largely (but not exactly) the same form governs the creation, perfection and priority of security interests in the relevant collateral.

> **Sponsor**: A sponsor issues USD-denominated floating-rate mortgage bonds in series. Each series is a direct, unconditional and senior secured obligation of a sponsor ranking pari passu, pro rata, and without priority among themselves. A mortgage bond is backed by a cover pool that remains on a sponsor's balance sheet. The cover pool is revolving. A sponsor grants to a Mortgage Bond Indenture Trustee (MBIT) a first priority perfected security interest in the cover pool for the benefit of the mortgage bond holders.

- **SPV**: The sole purpose of a bankruptcy-remote SPV is to launch a covered bond series and to use the proceeds to purchase a related mortgage bond series. The SPV grants a first priority perfected security interest in the related mortgage bond series and other covered bond collateral to a Covered Bond Indenture Trustee (CBIT) for the benefit of the secured creditors, including covered bond holders.
- **Bonds**: The existing covered bonds are limited recourse obligations of the SPV ranking pro rata and without priority among themselves. Investors have no further claim against the SPV or the sponsor if the proceeds from the enforcement of the first priority perfected security interest in the covered bond collateral are insufficient to meet their claims. The two statutory trusts organised under the laws of the State of Delaware with outstanding covered bonds are BA Covered Bond Issuer and WM Covered Bond Program.
- **Monitoring**: Bank of America and JP Morgan Chase Bank are supervised by the Office of the Comptroller of the Currency. The Bank of New York Mellon was appointed independent asset monitor to verify the arithmetic accuracy of the ACT calculations of both lenders yearly. If the sponsor were downgraded to or below a minimum level, the asset monitor would have to verify the ACT calculation monthly until the necessary credit ratings have been reinstated.

Criteria to ensure sustained collateral quality

The existing programmes provide the sponsors with considerable flexibility with regard to the composition of the cover pool. The eligibility criteria can be altered subject to approval of the credit rating agency then rating the outstanding covered bonds. Eligible as collateral are currently first-lien or second-lien residential mortgages and home equity lines of credit originated or acquired by the sponsor. In the case of Bank of America Covered Bond Issuer, loans in arrears for over 60 days must be excluded from the ACT calculation. For each loan, up to 75% of the property's value can be considered in the ACT calculation. A property's value is the value given to the property by the sponsor adjusted for changes by the Federal Housing Finance Agency House Price Index. Index declines are fully reflected in the reassessment of the mortgaged property's value, but only 85% of an index increase can be considered. Substitution collateral may be cash, debt issued or guaranteed by 0% risk-weighted public sector entities, exposures to 10% or 20% risk-weighted entities, and triple-A rated, USD-denominated RMBS. RMBS must not account for more than 10% of the total principal amount of the outstanding covered bonds. Substitution collateral is limited to up to 10% of the cover pool.

Monthly tests to ensure adequate collateralisation

A mismatch between a mortgage bond's coupon and the yield on the collateral in a cover pool is unhedged. The principal and core terms of a covered bond series match those of the related mortgage bond series. An SPV enters into derivative agreements with eligible counterparties to address risks arising from interest, currency and timing discrepancies between the mortgage bond and covered bond series. Derivative counterparties need to make payments to the SPV if and to the extent they receive payments. If the SPV fails to meet a scheduled payment, for example, if the FDIC as receiver or conservator does not authorise an interest payment on a sponsor's mortgage bond, the derivative counterparty needs to cover limited amounts of interest. Depending on the final terms of a series, the series is repaid in full on its maturity date or, if the SPV fails to repay the series in full on this date, repayment can be deferred. In accordance with the programme terms, a deferral can be up to 60 days. Payment deferral does not constitute an event of SPV insolvency. The individual programme terms provide for an ACT and a Proceeds Compliance Test (PCT).

- **ACT**: The sponsor performs this monthly test and ensures that the adjusted total loan amount is at least equal to the total unpaid principal amount of all outstanding mortgage bonds. The adjusted total loan amount is multiplied by an asset percentage, which is at least 96% for BA Covered Bond Issuer and 93% for WM Covered Bond Program, and refers to a minimum OC of 4.2% and 7.5%, respectively. An ACT is also carried out if collateral is removed from the cover pool or prior to the issuance of a new covered bond series. If the test is failed, the sponsor has to top up the cover pool to ensure that the ACT is passed again at the next calculation date. Consecutive failure of this test results in an event of sponsor insolvency.

> **PCT**: Upon an event of sponsor insolvency and declaration of acceleration of the mortgage bonds by the MBIT but before an event of SPV insolvency, the CBIT performs a monthly PCT. The CBIT assesses whether the sum of the total amounts deposited in, or credited to, the specified instrument for each covered bond series less any accrued interest, and the total unpaid principal amounts of each mortgage bond series is at least equal to the total principal amount of all outstanding covered bonds. A failure of the PCT constitutes an event of SPV insolvency.

Procedures upon an event of sponsor and/or SPV insolvency

If a sponsor becomes insolvent or is in an unsound condition, the FDIC may be appointed as conservator or receiver for the sponsor. In the event of sponsor insolvency, the cover pool turns static and the MBIT may declare the principal of all mortgage bonds and any accrued and unpaid interest thereon through the acceleration date to be due and payable (Mortgage Bond Acceleration). The cover pool and mortgage bonds would not be segregated from the estate of the sponsor. The FDIC, as receiver or conservator for a sponsor, currently has the following options in responding to covered bonds: (1) continue to perform the sponsor's obligations under the mortgage bonds and most likely seek to transfer the programme to another lender; (2) repudiate the mortgage bonds and pay an amount equal to the lesser of actual direct compensatory damages and the cover pool's fair market value; or (3) allow the cover pool to be liquidated by the MBIT and the proceeds to be used to pay an amount equal to the lesser of actual direct compensatory damages and the cover pool's fair market value. If the collateral were insufficient to fully back any recognised claim of the MBIT under the mortgage bonds, the MBIT would be an unsecured creditor of the sponsor as regards the portion of the claim that is unsecured.

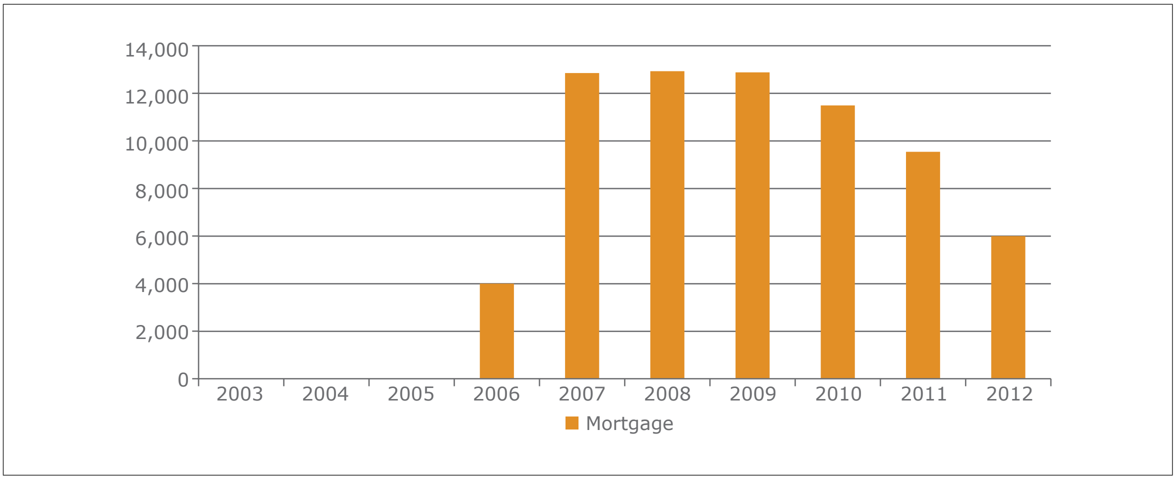
Upon an event of sponsor insolvency, the MBIT on behalf of the SPV has to deposit the cash from the liquidation of or the proceeds from the collateral in the cover pool into a specified instrument for each covered bond series. Reserves on each specified instrument have to be swapped to provide the funds needed to meet scheduled payments under the covered bonds. Funds standing to the credit of each specified instrument must not be commingled with a sponsor's other funds and assets. As long as the reserves on a specified instrument are sufficient to meet scheduled payments under the respective covered bond series, the covered bonds do not accelerate.

Following an event of SPV insolvency, the CBIT can declare all outstanding covered bonds to be due and payable against the SPV at their early redemption amount plus accrued interest (Covered Bond Acceleration). The CBIT may enforce its security interest over the covered bond collateral, liquidate it and exchange the proceeds with the derivative providers to prepay the covered bonds. No covered bond investor can proceed directly against an SPV unless the CBIT fails to take such action. If the proceeds from the enforcement of the security interest in the covered bond collateral are insufficient to meet the claims of the covered bond holders in full, no other collateral will be available for the payment of the deficiency.

II. RISK WEIGHTING & ECB ELIGIBILITY

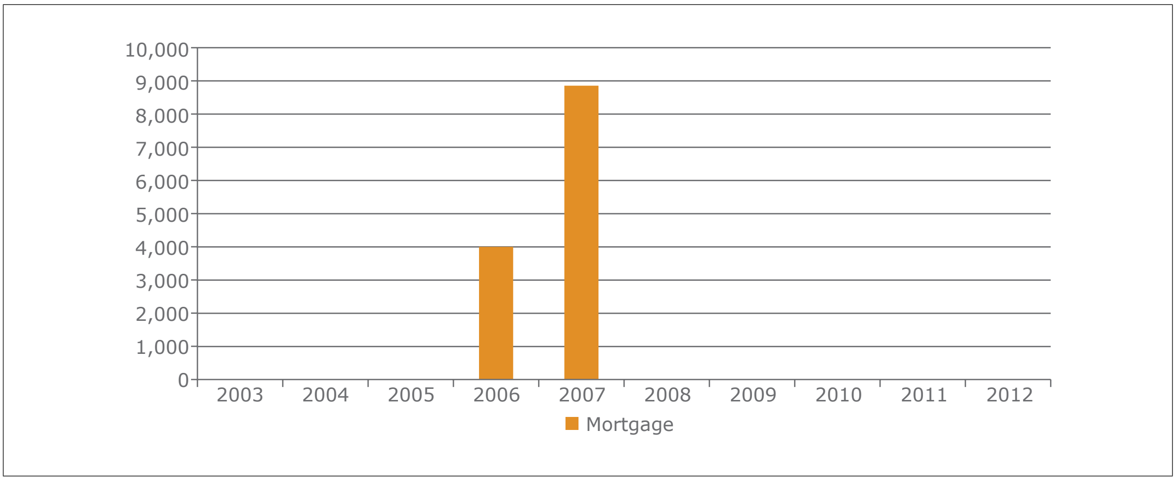
The outstanding general-law-based US covered bonds are not compliant with UCITS 52(4) and do not benefit from the higher investment limits as none of the current issuers is a credit institution with its registered office in a EU member state and subject by legislation to special public supervision designed to protect the bondholders. These bonds cannot be European CRD compliant without being in line with UCITS 52(4). Thus, the securities cannot benefit from special treatment in terms of risk weight. The Eurosystem accepts eligible assets as collateral for its credit operations. The outstanding EUR-denominated general-law-based US covered bonds are currently part of Liquidity Category IV.

> Figure 1: Covered Bonds Outstanding, 2003-2012, EUR m



Source: EMF/ECBC

> Figure 2: Covered Bonds Issuance, 2003-2012, EUR m



Source: EMF/ECBC

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/57/US_Covered_Bonds

CHAPTER 4 - RATING AGENCIES & METHODOLOGY

4.1 COVERED BOND RATINGS AND CRITERIA MORE STABLE THAN IN RECENT YEARS

By Boudewijn Dierick, BNP Paribas and
ECBC Rating Agency Approaches Working Group Chairman

In the last 12 months downgrades have continued to dominate the covered bond market rating spectrum though these have been more limited in frequency and number of notches.

Sovereign ratings in Europe seem to have become more stable. Most recent Covered Bond downgrades continue to be driven by lower issuer ratings as well as, in some cases, by the unwillingness or inability of certain issuers to increase the level of OC as required to maintain the ratings.

Rating agency methodologies for covered bonds have not been subject to significant changes during the last 12 months. As a result, the ECBC Rating Agency Approaches (RAA) Working Group has met less frequently than in the previous year.

Of the rating agencies, only Fitch updated its covered bond criteria, after publication of its request for comment "*The updated Global Covered Bonds Rating Criteria*" in July 2012. Fitch presented its updated criteria to the ECBC RAA working group. The latter provided Fitch with its written comments, as per its usual practice following publication of important covered bond criteria reports.

The changed criteria had less of a negative impact on ratings than expected, even though the higherspread assumptions for public sector assets led to higher OC requirements.

The D-cap which replaced the D-factor is easier to understand and more transparent. However the way it is derived means that one single factor could drive down the overall D-cap for a programme (so-called weak link approach). With the updated criteria, it has become more difficult for issuers, rated below single A, to reach a triple-A rating on their covered bond programmes.

Fitch also revised its assumptions for residential mortgage assets for certain countries.

In June 2013, Fitch published a special report on deposit set-off risk for structured finance and covered bonds. This was generally well received, as it supports the market view that the risk of losses, to covered bond investors from borrowers setting-off their payment obligations against deposits, is highly remote.

Moody's did not make any changes to its covered bond criteria. However, following their request for comment on their proposed swap counterparty criteriachanges published in 2012, Moody's still have not published updated (swap) counterparty criteria for covered bonds.

On 31 May 2012, Standard & Poor's published the *Covered Bonds Counterparty And Supporting Obligations Criteria* report which took into account feedback received from market participants. The report was considered an improvement, even though collateral requirements in case of downgrades of swap counterparties remain high. S&P also presented their criteria to the RAA working group. Following this publication, issuers had to submit an action plan outlining their intentions, and had to make the required modifications in their programmes by January 2013. As a number of issuers decided not to make their swap documentation fully compliant with the new criteria, this led to a handful of downgrades by S&P.

S&P published in April 2013 a request for comment titled "*Ratings Above The Sovereign - Corporate And Government Ratings*". They outlined changes they envisage implementing in their analysis of entities that may be rated above the rating of the sovereign in certain countries. It is expected that S&P will also apply similar criteria to covered bonds in terms of rating linkage to sovereign ratings. This is expected to follow the publication of a request for comments.

DBRS did not make any significant changes to its covered bond methodology for European covered bonds since it was published in August 2011.

CRA III REGULATION

The European Union's reform of Credit Rating Agency (CRA) Regulation, known as CRA III, was published in the Official Journal of the European Union on 31 May 2013 and entered into force on 20 June 2013. The final text has much less impact on the covered bond market than initially feared when initial proposals were published in 2011.

Various key items like mandatory rotation of rating agencies and minimum number of two rating agencies for all rated products do not apply to covered bonds and this positive outcome is partly thanks to the constructive discussions the ECBC has had with representatives of the European Securities and Markets Authority (ESMA) and the European Commission about the CRA III proposal.

SWAPS: EMIR, CENTRAL CLEARING AND ALTERNATIVES

Swaps are a the key feature of covered bonds and continue to be of great importance in mitigating interest rate and currency risks in covered bond programmes. This has become even clearer with the increased volumes of issuances by European issuers in the USD market.

All rating agencies have published very detailed covered bond swap counterparty criteria for which often incorporate high collateral posting requirements for swap counterparties in case of downgrades. These criteria, as well as regulatory changes, have made such swaps more costly and downgrades of various banks have reduced the number of eligible swap providers. For instance, not complying with rating agency criteria has resulted in downgrades of a number of programmes, following the implementation of new counterparty criteria by S&P in 2012.

The upcoming EMIR regulation will also have a significant impact on the swap market and will affect the way (covered bond) swaps are dealt with in the future.

For these reasons, it was decided during the RAA working group meeting held in May 2013 in Brussels to set up a swap task force group of experts that will

> Discuss with various Central Clearing Counterparties (CCPs) to (i) investigate further the possibility to centrallyclearcovered bond swaps and (ii) identify the major challenges to be addressed, like one-way collateral posting, collateral posting by a third party (parent of the issuer) or by a non-clearing member.

> Investigate in more detail if "standards" or "guidelines" can be developed for covered bond swaps that incorporate certain specific features already existing in many existing swaps but which do not necessarily comply with all standard rating agency counterparty criteria. This would make the swaps more marketable and, as a result cheaper and easier to replace, if and when needed, as well as more fitted to central clearing.

4.2 DBRS' RATING METHODOLOGY

By Vito Natale and Claire Mezzanotte, DBRS

INTRODUCTION

As described in the rating methodology "Rating European Covered Bonds", DBRS covered bond ratings are composed of the following three building blocks:

1. Issuer Rating (IR)
2. Assessment of each covered bond programme's Legal and Structuring Framework (LSF)
3. Cover Pool Credit Assessment

DBRS assigns a rating to a covered bond issuance using a step by step process. The first step is to determine the Maximum Achievable Rating (MAR) for a covered bond programme based on the IR and LSF assessment. Once the MAR is determined, a rating can be assigned to the covered bond issuance based on a Cover Pool Credit Assessment and evaluation of the sufficiency of programme over-collateralisation (OC) levels.

In cases where the application of the LSF matrices is not possible or would otherwise result in the same rating as the IR, DBRS may grant up to one notch uplift from the IR if the analysis of the Cover Pool shows that it would provide substantial support following a default on the Covered Bonds.

THE THREE BUILDING BLOCKS

1. Issuer Rating (IR)

The covered bond issuer is the primary source of the timely payment and repayment of both the interest and principal of a covered bond. As covered bonds have a dual repayment mechanism, covered bond holders have recourse to the issuer if the covered bonds are not fully repaid from proceeds of the cover pool (residual claim over "unsecured assets", pari passu with unsecured creditors). As a result, the IR is the anchor rating of a covered bond programme. The IR is assigned and monitored by the DBRS Financial Institutions Group (FIG) following the analytical process described in the relevant FIG rating methodologies. Each issuer rating has two components: Intrinsic Assessment (IA) and Support Assessment (SA). The Intrinsic Assessment is DBRS opinion about the issuer's intrinsic fundamentals whereas, the Support Assessment reflects DBRS opinion about the likelihood and predictability of timely external support for a bank, in case of need. Accordingly, the covered bond rating incorporates the support element that may exist in the IR. Because of the importance of the issuer in covered bond transactions, DBRS rates covered bonds only in cases where the issuer has a DBRS public or private rating or internal assessment.

2. Legal and Structuring Framework (LSF) Assessment

The LSF assessment is the largest of the three building blocks, as once the LSF assessment is assigned, DBRS can determine the MAR or Maximum Achievable Rating for a covered bond programme. Additionally, the LSF assessment implicitly limits the number of notches a covered bond can be rated above the IR.

Assessing the strength of the LSF primarily entails an in-depth review of the dedicated covered bond legislation and the legal environment of the relevant jurisdiction. This analysis is supported by external legal opinions when necessary. The second element of the LSF assessment is an in-depth review of the structuring features supplemental to the dedicated legislation. When such dedicated legislation does not exist or when an issuer chooses to issue outside of the relevant legislation, the LSF assigned solely reflects the contractual arrangements between transaction parties. Most importantly, the true sale agreements are reviewed to ensure bankruptcy remoteness of the CP in case of an issuer default.

The LSF grade is assigned by the DBRS Covered Bond team for each covered bond programme. DBRS analyses the specific terms of each covered bond programme to assess if the issuer manages the CP in a more conservative manner than required by jurisdictional laws. A more conservative approach by the issuer may benefit the covered bond. For example, in jurisdictions where covered bonds are issued directly from the issuer's balance sheet where repayment of mortgage credits is considered part of the segregated covered pool, the establishment of a bank account to hold collections in a segregated account may give more comfort in the continuity of cash flows in case of issuer insolvency and assigned a higher LSF grade, all else equal.

The LSF assignment is one of four grades: Very Strong, Strong, Adequate, and Modest. In addition to analysing the covered bond legislation to ensure segregation of the CP from the issuer's bankruptcy estate, DBRS assesses the current market environment, need and ability to liquidate the cover pool, and analyses structural qualitative features which may have an effect on the continuity of cash flows to the covered bond, in the case of issuer insolvency. This includes factors such as the existence and role of a regulatory supervisor in the normal course of business and issuer insolvency as well as contingency plans in case of issuer default.

Within the LSF assignment, DBRS incorporates sovereign risk by assessing the willingness and ability of regulators and central banks to support a covered bond programme. For example, although legislation within a jurisdiction ensures the cover pool assets are ring-fenced from the bankruptcy estate of an issuer and warrant an LSF of Very-Strong or Strong, a lower assessment may be assigned due to the risks related to a lower rated sovereign.

3. Cover Pool Credit Assessment and Cash Flow Analysis

The Cover Pool Credit Assessment begins with the structured finance rating approach used to analyse similar types of assets in asset-back transactions (e.g., RMBS, CMBS, etc.). Rating specific Probability of Default (PD) and Loss Given Default (LGD) assumptions are estimated for the cover pool after applying the appropriate methodology. Following the cover pool assets analysis, a multi-scenario cash flow analysis is conducted to incorporate the expected cash flows from the issuer and/or cover pool (including expected proceeds from the sale of all or part of the CP in case of issuer default), and liquidity provisions, as well as the interest rate stresses and currency stresses to ensure the all covered bonds within a programme receive timely interest and full principal by the stated maturity date under a scenario in line with the Cover Pool Credit Assessment.

The cash flow analysis assumes that if an issuer is solvent, all payments to the covered bond are made by the issuer. Post issuer insolvency, it is assumed that the cover pool (including any hedging contracts) will be the sole source of payment to the covered bonds. In addition to any proceeds received from the CP under normal repayment schedules, DBRS assumes that the cover pool will need to be liquidated at the appropriate time to repay covered bond interest and/or principal. The collateral liquidation value is estimated assuming a 0% conditional prepayment rate (CPR) on the cover pool with the cash flows discounted by a market value stress to calculate the Net Present Value (NPV) at liquidation. Three tiers of market value stresses were estimated by DBRS based on market value spreads for senior RMBS securities in multiple European jurisdictions.

SOVEREIGN STRESS

DBRS incorporates the probability of sovereign default into its asset level analysis by applying a sovereign related stress component to its stress scenarios. In addition, DBRS incorporates the ability of a sovereign to provide support to an insolvent covered bond issuer when assigning the LSF assessment.

DBRS LSF MATRICES

The probability of default of a covered bond is function of the joint probability of default of the Issuer and the Cover Pool, and a non-zero probability that the covered bond will receive the full benefit of the cash flows from the CP. This benefit is determined by the assignment of the LSF grade. The four categories are assigned so as this probability of not receiving such full benefit (increased possibility of disruption of cash flows) increases as the LSF weakens. The four LSF matrices are generated, for each of the LSF grades, based on an assumed Weighted Average Life (WAL) of the outstanding debt which is fixed at five years (see example in Appendix).

The ratings of the issuer and CP become a more constraining factor when determining the rating (within and up to the MAR) under Strong, Adequate, and Modest LSFs, as the impact of rating deterioration is magnified by the strengths and weaknesses of the relevant Legal Framework and supplementary structural features. Legal uncertainties and corresponding potential legal challenges, as well as lack or inadequacy of replacement mechanisms might increase delays and lengthen the time needed to transfer the CP to another bank or a special administrator in charge of maintaining timely payments to covered bond holders. These considerations lead to a reduced uplift for the covered bond rating vis-à-vis the IR in weaker LSFs, notably in "Adequate" and "Modest" assessment.

Once the matrices are generated and the LSF is determined, the MAR for a covered bond can be determined based on the IR and the "AAA" Cover Pool Credit Assessment. Ratings are assigned when programme OC level exceeds the target OC level for a given Cover Pool Credit Assessment in the LSF matrix.

COUNTERPARTY RISK

In covered bond programmes where there is an interest rate or currency swap, DBRS analyses the counterparty risk as detailed in the "Swap Criteria for European Structured Finance Transactions" methodology.

CB SURVEILLANCE

DBRS monitors outstanding covered bond ratings in accordance with the Master European Structured Finance Surveillance Methodology. As part of the surveillance of the CP Credit Assessment, DBRS monitors changes to the assets of the CP due to reinvestments and substitutions on a quarterly basis at a minimum. To the extent the quality of the Cover Pool degrades over time, the DBRS analysis may find that the OC level is insufficient to maintain the outstanding rating of the covered bond.

RELATED RESEARCH

> "Legal Criteria for European Structured Finance Transactions", June 2013.
  http://www.dbrs.com/research/258212/legal-criteria-for-european-structured-finance-transactions.pdf

> "Derivative Criteria for European Structured Finance Transactions", May 2013.
  http://www.dbrs.com/research/257489/derivative-criteria-for-european-structured-finance-transactions.pdf

> "Rating European Covered Bonds", January 2013.
  http://www.dbrs.com/research/253894/rating-european-covered-bonds.pdf

> Commentary: "The Effect of Sovereign Risk on Securitisations in the Euro Area". May 2012.
  http://www.dbrs.com/research/239786/the-effect-of-sovereign-risk-on-securitisations-in-the-euro-area.pdf

> Commentary: "DBRS Commentary on Italian Obbligazioni Bancarie Garantite Legal and Structuring Framework". December 2012. http://www.dbrs.com/research/253498/dbrs-commentary-on-italian-obbligazioni-bancarie-garantite-legal-and-structuring-framework.pdf

> Commentary: "DBRS Commentary on Spanish Cédula Hipotecarias Legal and Structuring Framework". August 2012. http://www.dbrs.com/research/250212/dbrs-commentary-on-spanish-c-dula-hipotecarias-legal-and-structuring-framework.pdf

Adequate LSF

ISSUER RATING / COVER POOL	AAA	AA (high)	AA	AA (low)	A (high)	A	A (low)	BBB (high)	BBB	BBB (low)	BB (high)	BB
AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AAA
AA (high)	AAA	AAA	AAA	AAA	AAA	AAA	AAA	AA (high)	AA (high)	AA (high)	AA (high)	AA (high)
AA	AAA	AAA	AAA	AAA	AAA	AAA	AA (high)	AA	AA	AA	AA	AA
AA (low)	AAA	AAA	AAA	AAA	AA (high)	AA (high)	AA	AA	AA (low)	AA (low)	AA (low)	AA (low)
A (high)	AAA	AA (high)	AA (high)	AA (high)	AA	AA	AA	AA (low)	AA (low)	A (high)	A (high)	A (high)
A	AA (high)	AA (high)	AA (high)	AA	AA	AA	AA (low)	AA (low)	AA (low)	A (high)	A	A
A (low)	AA	AA	AA	AA (low)	AA (low)	AA (low)	A (high)	A (high)	A (high)	A	A (low)	A (low)
BBB (high)	AA (low)	AA (low)	A (high)	A (high)	A (high)	A (high)	A	A	A (low)	A (low)	A (low)	BBB (high)
BBB	AA (low)	A (high)	A (high)	A (high)	A	A	A	A (low)	A (low)	A (low)	BBB (high)	BBB (high)
BBB (low)	A (high)	A (high)	A	A	A	A	A (low)	A (low	A (low)	A (low)	BBB (high)	BBB (high)
BB (high)	A (low)	A (low)	A (low)	A (low)	A (low)	BBB (high)	BBB (high)	BBB (high)	BBB	BBB	BBB (low)	BBB (low)
BB	A (low)	A (low)	A (low)	BBB (high)	BBB (high)	BBB (high)	BBB (high)	BBB	BBB	BBB (low)	BBB (low)	BBB (low)
BB (low)	BBB (high)	BBB (high)	BBB (high)	BBB (high)	BBB (high)	BBB	BBB	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BB (high)
B (high)	BBB	BBB	BBB	BBB	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BB (high)	BB (high)
B	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BB (high)	BB (high)	BB (high)	BB (high)
B (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BBB (low)	BB (high)	BB (high)	BB (high)	BB (high)	BB	BB
CCC (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB	BB	BB (low)	BB (low)
CCC	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB (high)	BB	BB	BB	BB (low)	BB (low)
CCC (low)	BB	BB	BB	BB	BB	BB (low)	BB (low)	BB (low)	BB (low)	BB (low)	B (high)	B (high)

4.3 FITCH RATINGS' COVERED BOND RATING METHODOLOGY

By Carmen Muñoz and Beatrice Mezza, Fitch Ratings

INTRODUCTION

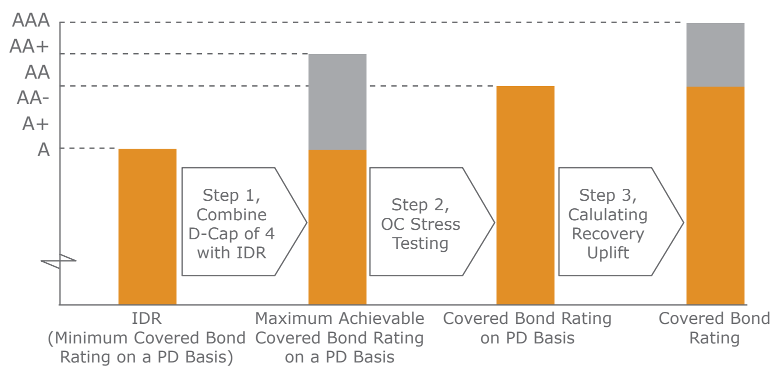
Fitch Ratings' covered bond ratings mainly address the bonds' probability of default (PD), but also incorporate an element of recovery given default. Fitch's covered bond rating methodology involves the following steps.

1. **Determining the maximum achievable rating for the covered bond on a PD basis.** This is achieved by analysing the payment discontinuity risk to determine how far the covered bonds' rating can exceed that of the issuer (or the financial institution acting as main debtor of recourse) from a PD standpoint. The difference is expressed through the Fitch Discontinuity Cap (D-Cap) which translates into a number of notches achievable above the institution's Issuer Default Rating (IDR).
2. **Stress-Testing Overcollateralisation (OC) to set the covered bond rating on a PD basis.** This process checks whether — post issuer default and considering OC between the cover pool and all outstanding covered bonds — cover assets cash flows enable payments on the privileged liabilities under Fitch's stress scenarios, corresponding to the covered bonds' maximum achievable rating on a PD basis.
3. **Defining the recovery uplift.** The assigned covered bond rating can be lifted above its rating on a PD basis by a maximum of two or three notches, depending on whether the rating on a PD basis is in the investment or sub-investment grade range. This is subject to OC taken into consideration producing outstanding stressed recoveries on covered bonds assumed to be in default.

In addition, Fitch assigns Outlooks to covered bond ratings to give an early indication of the potential future direction of a covered bond rating over a one- to two-year period. The main drivers of covered bond rating Outlooks are the relevant sovereign rating Outlook, the Long-Term IDR Outlook of the issuer, the economic and/or sector outlook associated with the assets comprising the cover pool and the outlook for the maintenance of OC within a programme.

Figure 1 illustrates the steps Fitch takes in rating covered bonds. Each step is examined in the discussion that follows.

> FIGURE 1: STEP-BY-STEP EXAMPLE OF A COVERED BOND RATING



IDR: Issuer Default Rating ; OC: Overcollateralisation ; PD: Probability of Default

Source: Fitch

1. DETERMINING THE MAXIMUM ACHIEVABLE RATING FOR THE COVERED BOND ON A PD BASIS

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 PD perspective for the covered bond rating.

The risk that a covered bond could default upon the insolvency of the issuing institution is evaluated through the Fitch D-Cap. The D-Cap conveys the maximum rating uplift from the financial institution's IDR to the rating that the covered bonds can achieve on a PD basis, provided OC between the cover assets and the covered bonds sustains the corresponding stress scenario. The range of possible D-Caps, together with their associated risk assessments, are as follows: 8 (Minimal discontinuity; for cases with no liquidity gaps, such as pass-through programmes with interest coverage for three months), 6 (Very low), 5 (Low), 4 (Moderate), 3 (Moderate high), 2 (High), 1 (Very high) and 0 (Full discontinuity; for cases where a covered bond default is expected upon issuer default). A D-Cap of 4 (Moderate discontinuity risk) means that the covered bonds' rating can reach four notches above the institution's IDR in terms of PD.

D-Caps are driven by the highest risk resulting from five published discontinuity risk components: asset segregation, liquidity gap and systemic risk, systemic alternative management, cover pool-specific alternative management, and privileged derivatives.

> **Asset Segregation:** Fitch analyses the strength of the asset segregation mechanism, notably whether it also places OC beyond the reach of other creditors until all covered bonds have been repaid in full. Other identified risks relate, for example, to the potential claw back of assets set aside for covered bond investors, commingling with the issuer's other cash flows, or borrower set-off rights.

> **Liquidity Gap and Systemic Risk:** In most programmes, incoming cash flows from the cover pool do not exactly match at all times payments due on the privileged liabilities. The analysis of the liquidity gap and systemic risk component considers liquidity risks, principal payment risks and systemic risks.
>
> Short-term liquidity shocks may arise from interest payments due shortly after an issuer's insolvency. Fitch expects programmes to provide protection, which covers at least covered bond interest payments over the next three months on a rolling basis, plus a buffer to cover senior expenses and potential interest rate movements.
>
> In terms of principal payment risks, Fitch first compares the time needed to monetise cover assets in a stress scenario to the length of time granted by the programme's protection mechanism. Fitch classifies cover assets in different categories depending on their assessed liquidation timing. Apart from pass-through programmes, where there is no reliance on asset liquidation post issuer default, temporary liquidity gaps arising in the aftermath of an issuer default can be compensated for by: an automatic extension of the maturity of the covered bonds; pre-maturity tests; mandatory liquidity requirements; and access to central bank market operations.
>
> For the systemic risk component, the rating of the sovereign in which the issuer and/or the cover assets are domiciled may serve as a constraint on the uplift the covered bond ratings can achieve from the issuer's IDR. Systemic risk issues are less likely to develop in higher-rated sovereigns. Therefore, the link between the issuer IDR and the covered bond rating becomes tighter if the sovereign is in the 'A' category and below. In a systemic crisis, Fitch expects it will be more difficult and will take more time to refinance cover pool assets in the event of an issuer default.

> **Systemic Alternative Management:** The agency studies the legal or contractual provisions for replacing an insolvent institution in its capacity as manager of the covered bonds and servicer of the cover assets. Fitch considers the timing of the appointment of a substitute manager or government administrator, as well as the scope of their responsibilities — whether exclusively focused on the interests of the covered bond holders or also encompassing other creditors — to be especially crucial to a programme's survival

following the issuer's insolvency. The agency will evaluate if the alternative manager has all powers and means to take the necessary actions, such as liquidating assets or borrowing against the cover pool, in order to make timely payments on the covered bonds.

> **Cover-Pool Specific Alternative Management:** The cover pool-specific assessment focuses on the likely ease of the transferability of relevant data and IT systems to an alternative manager and buyer, considering the quality and quantity of data provided to Fitch. Fitch evaluates whether cover assets, debtors' accounts and privileged swaps can be clearly identified within the issuing bank's IT systems, whether standardised rather than custom-made IT systems are used, the degree of automation and speed of cover pool reporting, and recordkeeping standards on loan documentation for cover assets and attached security. Dormant programmes may attract a worse risk assessment.

> **Privileged Derivatives:** Fitch considers programmes encompassing privileged hedging agreements to be more vulnerable to the default risk of the issuer. Unlike swaps in place for the benefit of the issuer pre-insolvency, privileged derivatives are designed to continue hedging the cover assets or the outstanding covered bonds post issuer insolvency. Both types of swaps may apply to a single cover pool, particularly when the pool is integrated in the balance sheet of the issuer. Replacement provisions for privileged derivatives post issuer insolvency may lack clarity, and replacing a defaulted counterparty may not be the priority of an alternative manager. Also, replacement prospects will vary depending on the characteristics of the swap. The agency differentiates between intra-group and external counterparties in its assessment, as the former provide covered bonds investors with less protection against the credit risk of the issuer than counterparties unrelated to the issuer banking group. Another consideration made is whether termination payments to swap counterparties rank pari passu with covered bonds.

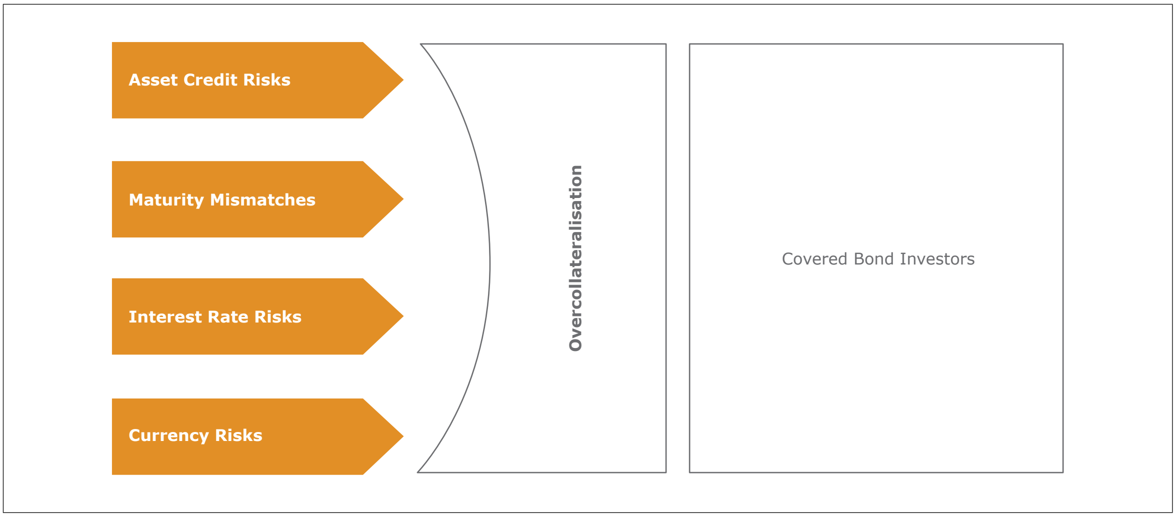
2. STRESS-TESTING OC TO SET THE COVERED BOND RATING ON A PD BASIS

In terms of PD, the covered bonds can be rated above the institution's IDR by the maximum number of notches indicated by the programme's D-Cap. Within this range, the rating of the covered bonds on a PD basis will correspond to the highest level of stress that the cover pool can withstand, factoring in the OC, while still enabling full and timely redemption of outstanding covered bonds in a wind-down scenario, should the issuer default. To test this, Fitch applies stresses which reflect expectations for the portfolio in an economic downturn, and compares the stressed cash flows that would be expected from the cover assets, including via their liquidation, to the payments due on the covered bonds under third-party management.

The four major sources of risk post issuer insolvency (see Figure 2) are stressed at each rating category. Stress scenarios include assumptions about the behaviour of the cover assets in terms of delinquencies, defaults, losses and voluntary prepayments. Stresses also reflect the cost of bridging maturity mismatches, and include relevant interest rate and cross-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.

OC between the cover pool assets and the covered bonds is the principal form of credit enhancement for covered bonds. Post issuer default, OC is intended to protect investors against the credit risks inherent in the cover pool and the market risks resulting from mismatches between the cover pool and outstanding covered bonds.

> Figure 2 : The four major sources of risk post issuer insolvency



Source: Fitch

To evaluate the asset risk, Fitch conducts a static analysis focused on the credit quality of the cover pool, in terms of the cumulative defaults and recoveries expected to arise in a given rating scenario, during a wind-down situation for the cover pool. The assessment of these risks depends on the nature and geographical location of the underlying assets or obligors. The agency makes specific assumptions about the assets' default likelihood, as well as the timing and magnitude of recoveries from the defaulted assets, for each type of collateral and jurisdiction. For similar assets, Fitch applies the same models and criteria as in structured finance transactions; as such, there will be consistency in the rating analysis for a given type of asset, irrespective of whether it serves as collateral for covered bonds programmes or structured finance transactions.

Unless the covered bonds are redeemable on a pass-through basis, the natural amortisation of the cover pool compared to the scheduled payments under the covered bonds may result in an excess or shortfall of cash. Fitch's cash flow model simulates the re-investment of any excess cash at sub-Euribor rates. Conversely, shortfalls of cash can be compensated by monetising the cover assets at a given sale price or cost of borrowing.

Fitch's stressed refinancing cost assumptions are derived from observable sale prices on comparable assets where available, such as publicly traded sovereign and local debt. For mortgage loans, Fitch generally assumes that the most likely buyers will be other mortgage covered bond issuers, who will take into account their own cost of funding when placing an offer. In the absence of pricing evidence for mortgage portfolio sales, Fitch uses secondary market spreads for residential mortgage-backed securities, covered bonds, and other relevant securities as a reference for calculating stressed refinancing costs. Fitch also applies a price cap for sales taking place immediately after an assumed issuer default, to reflect the likelihood of discounts being necessary to achieve a sale at this point (compared to a solvent seller).

If the OC taken into account does not withstand the credit risk, maturity, interest rate and currency mismatches, the cash flow model will fail, indicating that the tested rating scenario is too severe; hence, a less stressful scenario will be tested until the model passes. Through a reiterative process, the covered bond rating on a PD basis is set at the level corresponding to the highest rating scenario that, if applied to the cash flows, can be compensated through OC without leading to a covered bond default.

As the level of OC in covered bond programmes can change over time, as assets pay down and/or issuers actively manage their pools, Fitch gives credit — in decreasing order of comfort — to the following (when available) in its cash flow analysis:

> contractual commitments, if legally binding and enforceable against the issuer; and

> non-contractual public statements and/or covenants — such as undertakings given in the programme's investor reports, the bank's annual reports, or published on the investor relations section of the issuer's web site; or

> the lowest level of OC recorded during the preceding 12 months, provided that the issuer's Short-term IDR is at least at 'F2' and the programme is not in wind-down.

For issuers with a short-term IDR below 'F2' , or for programmes Fitch considers to be in wind-down or dormant, in the absence of valid contractual or otherwise public statements, the cash flow analysis will be run by giving credit only to the minimum level of OC, if any, required by the relevant covered bond legal framework.

3. DEFINING RECOVERY UPLIFT

Fitch's covered bond ratings do not fully reflect expected loss: indeed, the benefit given to recoveries from the cover pool in the event of a default under the covered bonds is limited to a two-notch uplift from the rating corresponding to the covered bonds' rating on a PD basis (if it is in the investment-grade range), and to three notches (if it is speculative grade). In its recovery analysis, Fitch disregards any potential recourse to the bankruptcy estate of the issuer. Covered bond investors often have an additional unsecured claim, ranking pari passu with the senior unsecured creditors of a bankrupt institution, to the extent that the proceeds from the cover pool liquidation are insufficient to repay their debt in full. However, it may not be practical for them to enforce their right if the two bankruptcy procedures do not start at the same time. The outcome is also subject to several uncertain parameters, such as the quality of non-cover-pool assets, and the capital structure prevailing at the time of the issuing institution's bankruptcy.

The recovery prospects are assessed, at the time of an assumed default of the covered bonds, by calculating the stressed Net Present Value (NPV) of the cash flows expected from the cover pool and comparing them with the NPV of the privileged liabilities (i.e. covered bonds and, if any, privileged swap agreements). The stresses applied are those that correspond to the rating of the covered bonds, incorporating the notching for potential recoveries, rather than the rating of the covered bonds on a PD basis. For instance, if the rating of the covered bonds is 'AA' on a PD basis, the programme can achieve a maximum of two notches above this for its recovery prospects. Stressed recoveries from the cover pool are then calculated in a 'AAA' rating scenario.

> Figure 3: Maximum notching above covered bond rating on a PD basis

			Maximum Notching	
Recovery Ratings	**Recovery Prospects**	**Recovery Range (%)**	**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

Most covered bond frameworks have cross-default clauses or specific provisions, such as the amortisation test, ensuring a pro-rata allocation of proceeds from the cover pool in the event of cover pool over-indebtedness. However, in other cases, the covered bonds law aims to prevent any early amortisation of covered bonds. As a result, Fitch assumes recoveries given default would be allocated sequentially in order of original maturities. This means that later maturing covered bonds may suffer a loss, while the earlier series of bonds could be repaid in full. For these programmes, Fitch will assume ongoing allocation of funds from the cover pool to make the payments that become due under the covered bonds, until the maturity date of the last maturing covered bonds, when the stressed value of the remaining assets will be assessed.

CONCLUSION

The covered bond ratings assigned by Fitch are driven by: the IDR; the discontinuity assessment; OC compared to the cover pool's credit risk; as well as maturity, interest rate and currency mismatches between the cover pool and the covered bonds. Whereas the IDR sets the floor for the covered bond rating on a PD basis, the discontinuity assessment indicates how far the covered bond rating on a PD basis can exceed the IDR. Finally, OC protects against credit risks in the cover pool and mismatches between the cover pool and the covered bonds; it also drives the level of recoveries on covered bonds assumed to be in default.

Among the 129 covered bond programmes publicly rated by the agency at end-April 2013, 79 were rated 'AAA'. The majority of these correspond to a 'AA+' or 'AA' rating on a PD basis and incorporate one or two notches for recovery given default. There has been significant downward rating migration for Fitch-rated covered bond programmes in 2011 and 2012, directly or indirectly related to the downgrade of the sovereign ratings of Greece, Cyprus, Italy and Spain. At end-April 2013, seven covered bond programmes rated by Fitch were rated in the non-investment-grade category, corresponding to programmes from Greece and Cyprus.

COVERED BONDS SURVEILLANCE

Fitch's covered bonds surveillance platform constitutes a single, comprehensive source of periodic information on key covered bond credit characteristics. It gives an overview of the IDR, the D-Caps and the covered bond ratings, including Outlooks, for all programmes publicly rated by the agency. A new rating history window lists all past rating actions at programme level since rating inception. Users will further find the amount of outstanding covered bonds and corresponding cover assets, highlighting available nominal OC as of each reporting date, as well as the breakeven percentage of OC (or asset percentage) for the assigned rating.

The surveillance pages contain graphs comparing the redemption profile of the cover assets to the covered bonds. They also display indicators of maturity, interest rate and currency mismatches between the cover pools and the covered bonds. Furthermore, the platform enables users to follow the composition of cover pools, such as geographical distribution for public sector assets or loan-to-value ratios for mortgage loans. This is a subscription service accessible from www.fitchratings.com.

Fitch Ratings' Applicable Covered Bond Criteria

> Covered Bonds Rating Criteria (10 September 2012)

> Covered Bonds Rating Criteria - Public Sector Liquidity and Spread Assumption Addendum (01 February 2013)

> Covered Bonds Rating Criteria – Mortgage Liquidity and Refinance Stress Addendum (03 June 2013)

> Criteria for Interest Rate Stresses in Structured Finance Transactions (25 January 2013)

> Asset Analysis Criteria for Covered Bonds of European Public Entities (30 January 2013)

> Criteria for the Analysis of Commercial Real Estate Loans Securing Covered Bonds (07 February 2013)

> EMEA RMBS Master Criteria (06 June 2013)

> Counterparty Criteria for Structured Finance and Covered Bonds (13 May 2013)

> Counterparty Criteria for Structured Finance and Covered Bonds: Derivative Addendum (13 May 2013)

4.4 MOODY'S COVERED BOND RATING METHOD

By Nicholas Lindstrom, Jane Soldera
and Juan Pablo Soriano, Moody's

This chapter is a summary of our covered bond methodology set out in the report "Moody's Approach to Rating Covered Bonds", 17 July 2012, available at Moodys.com.

OVERVIEW

Our rating for a covered bond is determined after applying a two-step process:

> Moody's Expected Loss (EL) Model: This determines a rating based on a largely quantitative calculation of expected loss, taking into account both the issuer's credit strength and the value of the cover pool following issuer default.

> Timely Payment Indicator (TPI): This applies a ceiling to the rating arrived at using Moody's EL Model. The TPI framework determines the maximum covered bond rating based on the issuer's credit strength and the TPI assigned to the programme. The TPI assigned will reflect the probability of timely payments continuing on the covered bonds if the issuer (or a rated entity supporting the issuer) can no longer support the covered bonds. We refer to this loss of support as *issuer default*.

MOODY'S EXPECTED LOSS (EL) MODEL

Our covered bond ratings are primarily determined by the expected loss under Moody's EL Model. The model assumes there is recourse, first, to the issuer and, second, to the cover pool. The model accordingly calculates the expected loss as a function of (a) the probability of issuer default; and (b) the subsequent losses (if any) on the cover pool. Following issuer default, the level of losses will be determined assuming a stressed environment. The key factors affecting the loss assumptions include:

> The credit quality of the assets in the cover pool;

> Refinancing risk, which arises when funds need to be raised to refinance the cover pool following issuer default; and

> Any interest-rate and currency risks to which the cover pool is exposed (both up to and at the time of refinancing the cover pool).

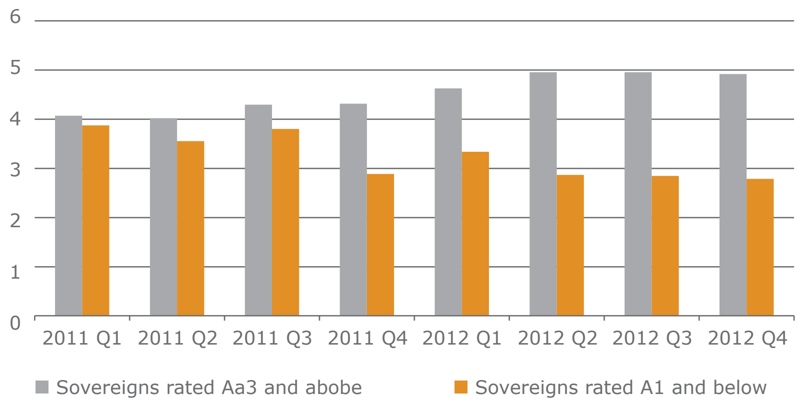
Moody's EL Model calculates expected loss on a month-by-month basis, from the point of issuance to the final maturity of a covered bond. For each period it calculates the probability of issuer default, on the basis of the issuer's rating and the estimated loss on the collateral (if any), assuming the issuer has defaulted. The results are then summed and discounted back to a net present value to give the overall expected loss on the covered bond.

MOODY'S EL MODEL - ROLE OF THE ISSUER

The issuer's role is crucial to the performance of a covered bond programme. Before issuer default, we assume the issuer is performing its obligations and there should be no loss to covered bondholders. To assess the risk of issuer default, we look to the issuer's senior unsecured rating or, if the issuer is unrated, we may use the rating of another group entity provided it has a sufficiently robust obligation to provide financial support to the issuer. Alternatively, the issuer's senior unsecured rating may not be the best reference point for issuer default should the rating reflect risks, such as "bail-in", that may not apply to covered bonds. We may adapt our analysis to a different reference point[1] depending on how bank resolution frameworks, in particular, develop.

Moody's EL Model also takes into account various issuer and issuer group-related benefits in addition to the issuer's credit strength. For instance, the issuer will normally actively manage the cover pool to the benefit of the covered bondholders: this may include replacing defaulted assets with performing assets, or replacing high loan-to-value (LTV) loans with lower LTV loans, particularly if this is required by law. This kind of support from the issuer explains why the issuer's role is more important than that of a simple guarantor.

> FIGURE 1: SIMPLE AVERAGE NUMBER OF NOTCHES UPLIFT OF COVERED BOND RATING OVER ISSUER RATING (COUNTRIES STATICALLY DISTRIBUTED BY THEIR SOVEREIGN RATING AS OF END OF Q4 2012)



Source: Moody's European Covered Bonds Monitoring Overview, Q4 2012

MOODY'S EL MODEL - VALUE OF THE COVER POOL AFTER ISSUER DEFAULT

To avoid losses on covered bonds following issuer default, the realisable value of the cover pool, including any over-collateralisation, will need to be sufficient to cover the principal and interest payable on the covered bonds. In our analysis, there are three key factors affecting the value of the cover pool: (a) the credit quality of the collateral; (b) refinancing risk; and (c) interest rate and currency risks. Taken together, refinancing risk and interest rate and currency risks are referred to as *market risks*.

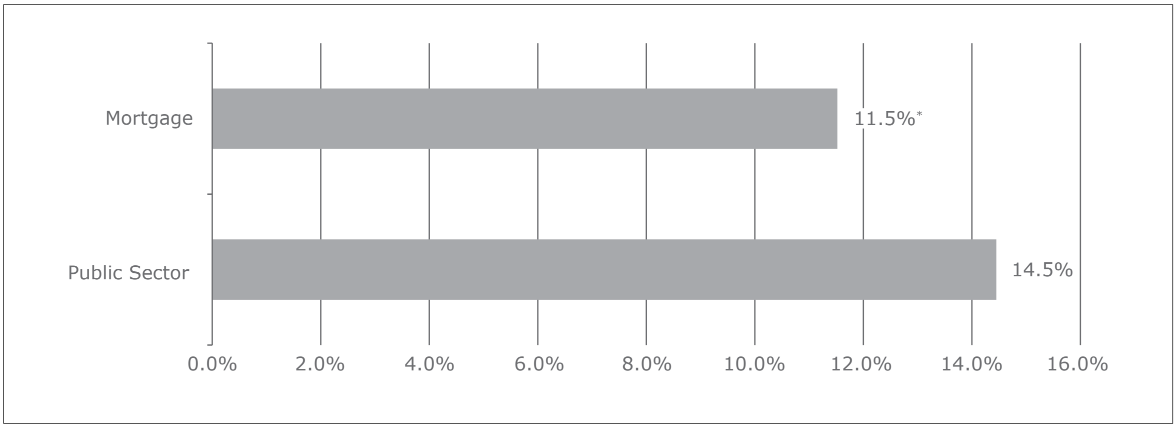
1. Credit quality of the collateral in the cover pool

We determine the credit quality of the cover pool by estimating the level of borrower loan losses that will accrue after issuer default in a highly stressed environment. The collateral score measures the level of loss, whereby the lower the collateral score, the stronger the credit quality of the cover pool. Factors that affect the collateral score vary, but for mortgage loans they will normally include (i) the performance of the relevant property market(s); (ii) the range and distribution of loan-to-value ratios; (iii) the quality of the loan underwriting (in particular, the calculation of whether the borrower can afford the loan); (iv) the seasoning of the pool; and

1 For more details on possible alternative approaches to issuer default, please see "Global Covered Bonds: 2013 Outlook", December 2012, page 10.

(v) the type of loan product, for example, amortising or interest-only. Factors most relevant for public-sector loans will include the credit strength of the public-sector borrowers and concentration levels of those loans. The credit quality of the cover pool may vary over time, as issuers typically have discretion to add and remove assets, but we monitor this by re-calculating on a quarterly basis the collateral score for most programmes.

> FIGURE 2: SIMPLE AVERAGE COLLATERAL SCORE BY COVERED BOND ASSET TYPE



*excludes systemic risk

Source: Moody's European Covered Bonds Monitoring Overview, Q4 2012

2. Refinancing risk in the cover pool

The expected maturity of the assets in the cover pool is generally longer than that of the covered bonds. This mismatch means that, following issuer default, funds may need to be raised against the cover pool to enable timely payment of principal on the covered bonds. Moody's EL Model assumes that when funds must be raised against the cover pool this will be done at a discount to the notional value of the cover pool. The refinancing environment for the assets at this time is likely to be stressed and this is taken into account in the level of discount we build into our credit enhancement assumptions for a given rating level.

The credit enhancement necessary to address refinancing risk is based on three factors:

(a) The level of discount required to sell or refinance the assets (referred to as *refinancing margin*);

(b) The portion of the cover pool exposed to refinancing risk; and

(c) The average life of the refinancing risk, i.e. the average duration of the refinancing risk for assets in the cover pool at the time of issuer default.

For (b) and (c), we typically assume that the portion of the cover pool exposed to refinancing risk is a minimum of 50% and, at time of issuer default, the average duration of the refinancing risk is a minimum of five years.

For (a), the refinancing margins are set by reference to each jurisdiction and then adjusted for individual programmes. Factors that influence the refinancing margins in our analysis include (i) on a jurisdiction level, the margins observed for covered bonds in a given market; (ii) on programme and/or jurisdiction level, the mitigants to refinancing risk; and (iii) on a programme level, the collateral quality.

3. Interest-rate and currency risks in the cover pool

Following an issuer default, investors in covered bonds may be exposed to interest-rate and currency mismatches. These mismatches result from different interest rates, the duration of these rates, and different currency denominations of cover pool assets compared with the covered bonds.

Under Moody's EL Model, the potential mismatches are estimated by taking into account:

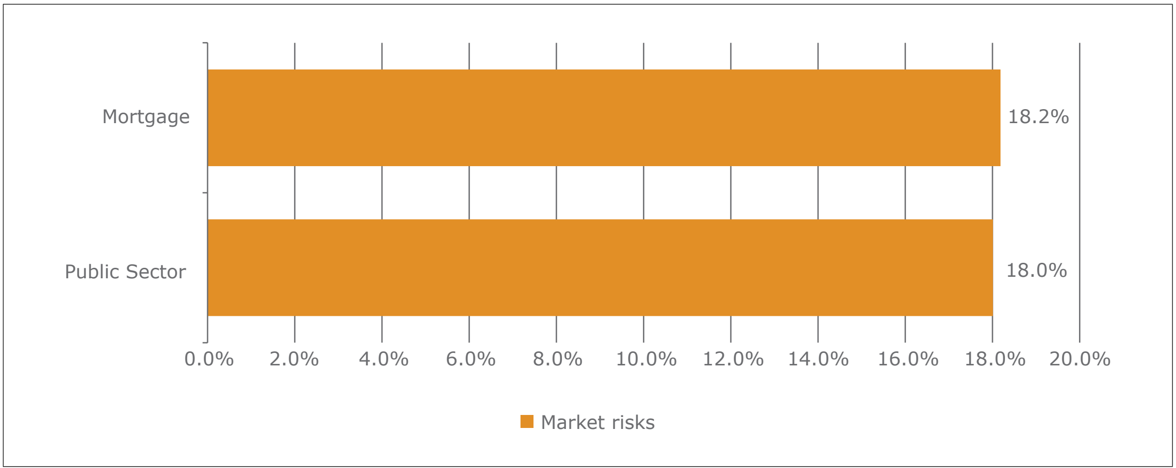
(a) The size of the possible interest-rate (or currency) movement over the relevant period, for example looking at the impact of increasing and decreasing interest rates and taking the path that leads to the harshest expected loss on the covered bonds;

(b) The portion of the assets with interest-rate (or currency) mismatches; and

(c) In the case of interest-rate risk, the average duration of the mismatch based on how quickly the rates or margins on the assets in the cover pool may be adjusted.

Moody's EL Model takes into account whether there is hedging with derivatives in place at the point of issuer default and the probability of the derivative terminating at issuer default, or subsequently. Generally, the lower the probability of a derivative terminating, the lower the risk of an interest-rate or currency mismatch arising; however, in no case do we currently assume that derivatives used to hedge interest-rate and currency risk completely and permanently remove these risks from a covered bond.

> FIGURE 3: SIMPLE AVERAGE MARKET RISK BY COVERED BOND ASSET TYPE



Source: Moody's European Covered Bonds Monitoring Overview, Q4 2012, extract.

MOODY'S TIMELY PAYMENT INDICATORS (TPIS)

Following issuer default, the issuer can no longer be relied on to make timely payments on the bonds and bondholders must therefore rely on external support, liquidity and the legal/ contractual framework of the bonds to provide for timely payment. A "timely payment indicator" or "TPI" is Moody's assessment of the likelihood that timely payment would continue to be made to covered bondholders following issuer default. TPIs range from "Very High" to "Very Improbable".

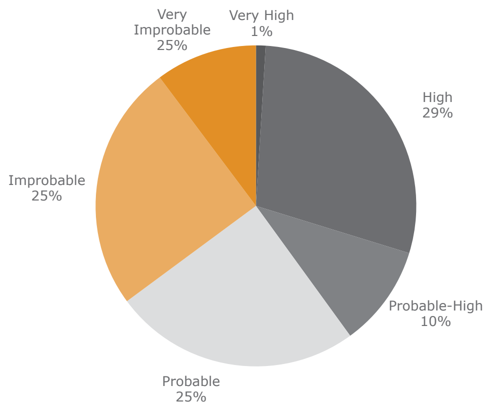
TPIs indicate a ceiling for the rating of a covered bond that limits it to a certain number of notches above the issuer's rating. We determine TPIs on a jurisdiction-by-jurisdiction basis as many of the factors we analyse are common within jurisdictions. TPIs may then be adjusted at the programme level to reflect particular features of a programme. We publish a TPI Table setting out the expected maximum covered bond ratings for different issuer rating/TPI combinations (see Moody's rating methodology report referred to at the end of this chapter). We will normally determine the rating ceiling based on the TPI table; however, for some programmes the actual rating ceiling may be higher or lower, particularly if the issuer has a low investment-grade rating, or is rated below investment grade.

We consider a range of qualitative factors to determine TPIs. The most important of these – and the biggest risk to timely payment for most covered bonds – is the existence of refinancing risk. This risk is highly volatile, which is why our highest ratings cannot be maintained on covered bonds that are subject to material refinancing risk, unless they are also backed by a highly-rated issuer.

One important way in which we assess the effects of refinancing risk for each jurisdiction is to consider covered bonds' systemic importance in that jurisdiction. We consider whether, following an issuer default, covered bonds would be likely to receive support from the government or market participants[2]. Other factors that we consider relevant to TPI levels include (i) continuity of servicing and cash management; (ii) the risk that any relevant swaps might be terminated; (iii) the risk of acceleration of the covered bonds; (iv) enhancement levels; and (v) the issuer's ability to change the programme (in particular to add new assets and enter into new hedging arrangements).

Following the downgrades of euro area countries over the last few years, sovereign risk has been the main driver for reductions in TPI levels in the affected countries. In countries with weaker creditworthiness, the stresses on the government and financial system may mean the government and market participants are less willing and/or able to provide funds to support refinancing of covered bonds following issuer default. For more details on the impact of sovereign downgrades on covered bond ratings see our reports *European Covered Bonds: Sovereign Downgrades Key to Bond Rating Migration* and *European Covered Bonds: Downgrades Accelerate due to Bank and Sovereign Credit Deterioration* (listed below).

> FIGURE 4: TPI DISTRIBUTION



Source: Moody's European Covered Bonds Monitoring Overview, Q4 2012.

2 However, if we consider a reference point for issuer default other than the issuer's senior unsecured rating, some of these factors may be incorporated into our assessment of the new reference point, i.e. the probability that the covered bonds will be supported within a framework of issuer support, for example by transfer to a "good bank" under resolution procedures.

References:

> Moody's EMEA Covered Bond Monitoring Overview: Q4 2012 (updated quarterly)

> Moody's Approach to Rating Covered Bonds; 27 July 2012

> European Covered Bonds: Sovereign Downgrades Key to Bond Rating Migration; 5 March 2012

> European Covered Bonds: Downgrades Accelerate due to Bank and Sovereign Credit Deterioration; 30 October 2012

> Global Covered Bonds 2013 Outlook; 13 December 2012

> Assessing Swaps as Hedges in the Covered Bond Market; 17 September 2008

> European Covered Bond Legal Frameworks: Moody's Legal Checklist; 9 December 2005

4.5 STANDARD & POOR'S

By Roberto Paciotti and Karlo Fuchs, Standard & Poor's

Standard & Poor's Ratings Services' covered bond rating approach is explained in the criteria "Covered Bond Ratings Framework: Methodology And Assumptions," published on 26 June 2012, and available on the Global Credit Portal and at www.standardandpoors.com/coveredbonds.

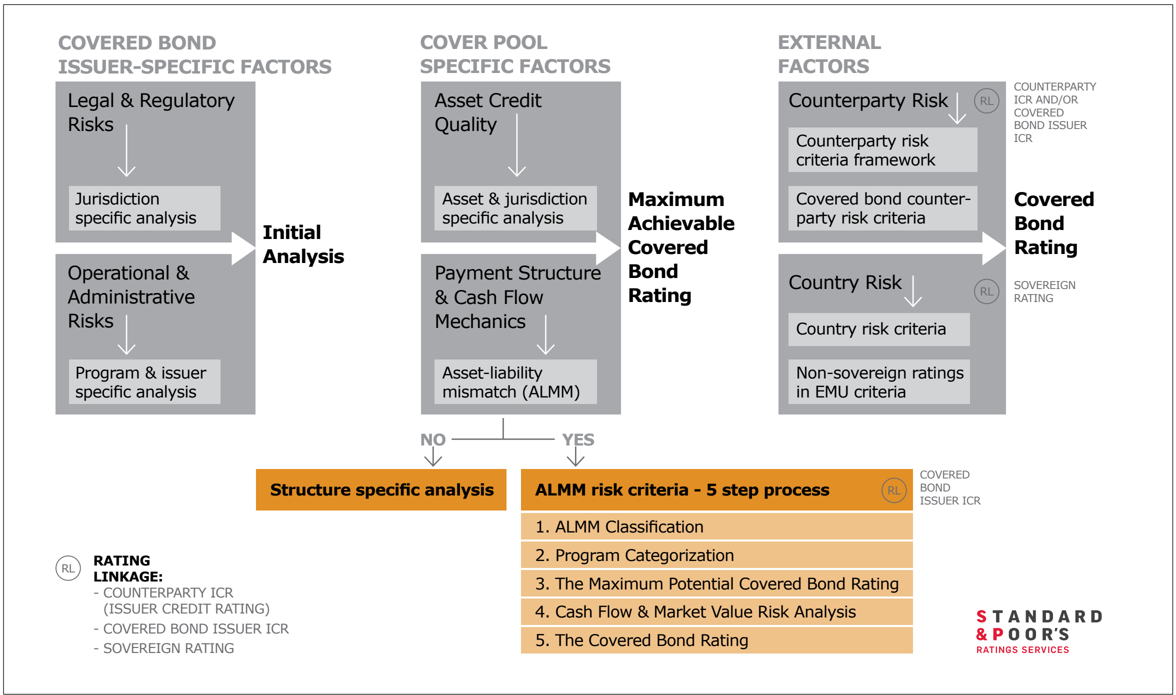
S&P's criteria reflects its belief that the rating on a covered bond exhibiting mismatches between the underlying assets and the covered bond liabilities should be linked to the issuer credit rating on the issuing or sponsor bank. Only if a covered bond can be isolated from that bullet repayment risk can S&P rate the covered bonds on a de-linked basis from the issuer.

When the programme is exposed to asset-liability maturity mismatch (ALMM) risk, the maximum potential rating uplift the covered bond rating can achieve above the issuer credit rating is up to seven notches. Therefore, this approach results in the assignment of 'AAA' ratings only to covered bonds of highly rated issuers, provided that S&P believes the programme has sufficient credit enhancement to cover all relevant risks, in particular market value risk arising from the asset-liability mismatch.

The covered bond ratings framework determines the covered bond rating in three key stages (see figure 1):

1. We perform an initial analysis of covered bond issuer-specific factors (including the operational and administrative risks, the assignment of an issuer credit rating as the starting point for the covered bond rating, and the assessment of the legal framework that is governing the issuance);
2. We determine the maximum achievable covered bond rating based on cover pool-specific factors; and
3. We combine the results of the above and consider additional factors such as country and counterparty risks to assign the final covered bond rating.

> Figure 1: Covered bond ratings framework – based on principles of ratings



ASSET AND CASH FLOW ANALYSIS

Asset analysis

The underlying cover pools typically contain residential mortgage loans, public sector bonds and loans, or some other form of high credit-quality collateral. Using jurisdiction- and asset-specific assumptions, S&P analyses these pools to form a view on the expected stressed asset performance. The credit analysis also incorporates issuer-specific aspects such as the impact of its underwriting policies or its collateral management.

Cash flow analysis and market value risk

Established covered bond programmes typically issue debt with a broad range of maturities and there is an inherent timing mismatch between the redemption of assets and that of the liabilities. The timing and weighting of the degree of this mismatch is important in S&P's analysis. Generally, the expected cash inflow from the cover pool can partially mitigate some of the ALMM risk. In most circumstances, however, there remains a need for the underlying cover pool assets to be sold or otherwise liquidated to repay each series of covered bonds at its bullet maturity, especially under the assumption of a defaulted issuer – which is what S&P considers to happen. The market value risk assumptions S&P makes are a function of its view of the relative liquidity in the market for these same assets and a stressed discounting of cash flows.

To assess the effect of asset-liability mismatches, the rating analysis thus focuses on the covered bond programme's ability to pay its obligations based on the cover pool. S&P has devised a five-step process to evaluate the maximum potential ratings uplift for a covered bond programme based on a combined assessment of its ALMM risk exposure, its program "categorization" and the available credit enhancement.

> Step 1: Classification of the asset-liability mismatch

S&P first calculates its view of a programme's ALMM exposure and classifies this exposure based on its magnitude. In this step, S&P includes stresses to the cash flows to cover asset credit risks and any other risk (but market value risk) to which the covered bonds may be exposed. Any structural features (such as bond extensions or liquidity facilities) that may affect the asset-liability mismatch are also factored into the rating analysis.

S&P then considers the timing of the mismatch in the asset-liability analysis and treats near-term mismatches as being more significant than those occurring in the medium or long term. The ALMM percentage used to classify the programme is the maximum cumulative mismatch expressed as a percentage of a programme's outstanding liabilities. Based on these stresses and assumptions S&P classifies each programme as a "low", "moderate" or "high" ALMM risk.

> Step 2: Programme categorization

Secondly, S&P segments covered bond programmes predominantly by country, based on the range of external funding options available to the programme and S&P's view on the likelihood of obtaining this funding. The programmes fall into one of three categories, each of which has a range of maximum potential ratings uplift. The broader the range of funding options and the more well-established and systemically important S&P believes the covered bond product is in a particular country, the higher is the potential uplift.

> Step 3: The maximum potential covered bond rating

In this step S&P evaluates the maximum degree to which a programme's rating may potentially exceed the issuing bank's rating. S&P combines its assessments of a programme's ALMM exposure (from step 1) and its ability to cover such liquidity needs (as defined by its programme categorization from step 2) in the matrix below. The maximum potential rating on a covered bond is calculated as the bank's issuer credit rating increased by the appropriate number of notches derived from the matrix. This potential uplift assumes that the programme's available credit enhancement equals the target credit enhancement (see step 4). Covered bonds may be either issued directly by a bank or via a special-purpose entity. In the case of direct issuance by a bank, S&P would expect the bank to have either a public or confidential S&P rating. For programmes using an unrated subsidiary or special-purpose entity, S&P applies its criteria for Financial Institutions, "Group Rating Methodology And Assumptions," published Nov. 9, 2011, to determine the starting point of the elevation.

> Figure 2: Maximum potential ratings uplift from the issuer's ICR, by number of notches

ALMM risk	Category		
	1	2	3
Zero	Unrestricted	Unrestricted	Unrestricted
Low	7	6	5
Moderate	6	5	4
High	5	4	3

> Step 4: Cash flow and market value analysis

S&P then sizes the target credit enhancement level that, in its view, is commensurate to support the maximum potential ratings uplift. In this step we analyze all those risks we believe the cash flows are exposed to and in particular apply market value stresses to assets that need to be sold in situations where asset-liability mismatches occur and there is a liquidity need. If S&P's analysis indicates that a programme can liquidate enough assets to meet such mismatches, while leaving sufficient collateral to service the remaining debt, it can achieve its maximum potential covered bond rating. S&P models market value risk by applying an additional asset dependent "spread shock" when calculating a stressed net present value of the cash flows of the assets to be sold. In its calculation of the target credit enhancement, S&P also incorporates its asset default stresses and any interest and currency stresses to the extent not appropriately hedged.

To analyze whether the credit enhancement provided is commensurate with the maximum achievable rating, S&P reviews the following risks: asset default risk (including counterparty risk), interest rate and currency risks, and market value risks arising from asset-liability mismatches.

> Step 5: The covered bond program rating

Lastly, S&P determines a rating on the programme that reflects the cover pool's actual level of credit enhancement. In this step, S&P assesses whether the available credit enhancement in a programme is equal to or higher than the target credit enhancement for the maximum potential rating given in step 3. If this is the case, the programme can achieve the maximum potential rating. If this is not the case, S&P assigns the first notch of uplift if the available credit enhancement covers all credit risks related to the default of the cover pool assets (including counterparty-related risk such as not appropriately mitigated bank account and commingling risk). The remaining credit enhancement is compared with the additional notches of potential ratings uplift to determine the uplift achievable.

The assignment of outlooks

Under its criteria, S&P's assigns an outlook to all covered bond ratings. These provide a view of a programme's potential for a rating change and its direction over the intermediate term (see "General Criteria: Use Of CreditWatch And Outlooks," published Sept. 14, 2009). The covered bond outlooks take into account S&P's views on the outlook on the issuer, the level of ratings uplift achieved, the likelihood of changes in ALMM risk, as well as potential rating changes due to the performance of the collateral.

The quarterly publication "Global Covered Bond Characteristics" (see www.standardandpoors.com/coveredbonds) gives an overview on the key credit and cash-flow indicators of the programmes that S&P rates.

NON ASSET AND LIABILITY RELATED RISKS

In addition to the analysis of the risks outlined above, S&P also reviews any legal risks, operational and administrative risks, and any counterparty or country exposures to determine whether these are commensurate with the rating being assigned as per step 5 above. These risks might further constrain the achievable covered bond rating even if sufficient overcollateralization is provided.

Legal risks

S&P typically reviews the following legal aspects when assigning a rating to a covered bond programme:

> The nature of the segregation of the assets and cash flows if the issuing bank fails (i.e. becomes insolvent);

> Whether there is any acceleration of payments to noteholders if the issuing bank fails—whether payments of interest and principal will continue in accordance with the original terms of the covered bonds;

> Whether there is any payment moratorium or forced restructuring;

> Whether there are any limits to overcollateralization levels, i.e., if a programme may overcollateralize its covered bonds above the minimum limit defined under the legislation or the programme documents, and whether this additional overcollateralization is available to the covered bond holders notwithstanding the issuing bank's failure;

> The treatment of any hedging agreements if the issuing bank fails;

> Whether the programme can access funding after the issuing bank's failure; and

> The management of the cover pool both before and after the issuing bank fails.

Operational and administrative risks

S&P also reviews the issuer's origination, underwriting, and servicing operations to assess whether to factor any additional risks into its rating process. The assignment and regular monitoring of a public or confidential S&P rating to the covered issuer is mandatory for programmes exposed to ALMM risk.

Counterparty risks

To the extent a programme benefits from any interest rate or currency hedges to address any interest rate or currency mismatches, S&P reviews the underlying agreements to assess whether they conform with its relevant counterparty criteria. Deviations can result in either capping the maximum achievable covered bond rating or incorporating the unhedged risks into the sizing of the target credit enhancement. In its analysis, S&P also assesses how other counterparties that provide support to the transaction could impact the rating. This also includes whether account bank risk is adequately mitigated or whether in the event of an insolvency of the issuer, cash flows could become commingled and ultimately lost. The loss of cash flows, in our view, must also be seen as an asset default related risk. If not mitigated as we would expect according to our criteria, we typically incorporate any such risk when determining the level of overcollateralization we believe is sufficient to assign a covered bond rating that is at least one notch above the covered bond issuer credit rating.

Country risks

When we assess covered bonds, we analyze the underlying assets' and transaction's sensitivity to country risk and the asset portfolio's diversification by jurisdiction. For covered bonds rated above the sovereign and issued from within the European Monetary Union (EMU), we assign, according to our EMU country risk criteria, an assessment of "low" or "high" to a covered bond's country risk exposure. We typically consider asset pools of domestic public sector assets to have "high" exposure to country risk. We currently classify as "low" the country risk exposure of covered bonds backed by commercial or residential mortgage loans due to their perceived lower sensitivity to a sovereign default.

We determine the maximum rating differential between sovereign and covered bond ratings based on the sovereign rating level and the covered bond programme's country-risk exposure (see "Non-Sovereign Ratings That Exceed EMU Sovereign Ratings: Methodology And Assumptions," published on June 14, 2011). This assessment caps any potential further uplift typically available under our criteria for rating covered bonds.

A covered bond programme that has what we consider to be a "high" country-risk exposure would typically only achieve a one-notch uplift above the rating on the country in which the cover pool assets are located. A "low" country-risk exposure allows a maximum uplift of up to six notches above the investment-grade rating on the country in which the cover pool assets are located. If the sovereign's rating is in the speculative-grade category, the maximum uplift is five notches.

We have published an advance notice of proposed criteria changes ("Methodology And Assumptions: Advance Notice Of Proposed Criteria Change: Ratings Above The Sovereign--Structured Finance", on April 12, 2013) and will publish a request for comment in due course. Following a consultation and considering market feedback we will publish structured finance criteria to replace the current EMU framework for rating covered bond above the sovereign.

ASSIGNING AND MONITORING THE RATING

The outcome of S&P's rating analysis is a rating on the covered bond programme and the bonds that the programme issues. S&P is committed to providing a written rationale of its rating decision and any changes to the rating as a result of the ongoing surveillance S&P does on that programme.

CHAPTER 5 - COVERED BOND STATISTICS

5.1 INTRODUCTION

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

INTRODUCTION

The ECBC Statistics and Data Working Group has been collecting statistics on the outstanding volume and annual gross supply of covered bonds at year end for 10 years now. From the start its aim has been to provide a complete set of numbers that can serve as guidance for interested parties from issuers and investors to regulators.

The collection of statistics is a significant undertaking each year which is only possible thanks to the cooperation of the Working Group members, covered bond issuers and banking associations. One representative per country (the list of country representatives can be found on the ECBC website) undertakes the initial data collection by approaching each issuer separately in most countries. These figures are then cross checked on the basis of publicly available data by a small number of Working Group members. The 2012 numbers were cross checked by Anne Caris and Rondeep Barua from Bank of America Merrill Lynch, Jan King from Royal Bank of Scotland, Florian Hillenbrand from Unicredit Group, Agustin Martin from BBVA and Johannes Rudolph from HSBC.

GENERAL REMARKS ON THE 2012 STATISTICS

The aim of the ECBC statistics is to paint as realistic a picture of the actual market as possible. We have taken the 10th anniversary to go through the data that we collect and ask ourselves whether we are still showing relevant information or whether we are missing something. In the past we had divided the statistics into five categories:

1) covered bonds backed by mortgages, public sector debt, ship loans or a mix thereof;
2) non-Jumbos or Jumbos;
3) privately or publicly placed covered bonds;
4) those denominated in euro, those in domestic currency (if not the euro), or those in a currency other than the euro and the domestic currency; and
5) fixed-rate or floating-rate covered bonds, or covered bonds with another coupon structure.

As a result of our analysis we have undertaken a few changes to the way we group and show data compared to the last years as we believe it paints a more realistic and also more relevant picture:

1) We have changed the break-down by collateral type from "public sector", "mortgage", "ship" and "mixed" to "public sector", "mortgage", "ships" and "other".
2) We have changed the way we break down the covered bond market into deal sizes and placement characteristics by merging the non-jumbo vs. jumbo as well as the privately vs. publicly placed covered bonds into one new category. This new category is now broken down into public benchmark covered bonds above 1 bn, public benchmark covered bonds between EUR 500 mn and EUR 1 bn, public issues below EUR 500 m as well as private placements. We have also changed the definition of what is considered public and private. The definition for public placement we used for the 2012 data states that a bond has to be listed and syndicated to fall into one of the public placement categories. If either or both of these two conditions are not met, we move the bond into the private placement bucket.

The new breakdown by collateral type is a reflection of the covered bond market having become more heterogeneous in recent years. We are by now not talking about mortgage, public sector or ship assets anymore but a wider range of collateral types including for example aircraft mortgages in Germany. These newer collateral types are at this point still a small minority only but we still cannot ignore them. By breaking the covered bond market down in these four new collateral categories, we enable investors to track the evolution of covered bonds backed by these newer vs. those still backed by the traditional collateral types.

There are also good reasons for us to merge the former jumbo vs. non-jumbo and private vs. public placement this year. In the past, the definition of private vs. public placement was not always consistently applied across countries. Some countries reported bonds in the public bucket the moment they were listed (which included retained covered bonds), others only those that had been ultimately placed with end investors. The result was that the public placement bucket did not always represent the "investable" covered bond market but also included retained covered bonds that investors had no access to. The figures were thus misleading and missed our aim to enable investors to find markets that are sizable enough to make starting a deeper analysis a worthwhile project.

Secondly the concept of jumbo covered bonds has lost much of its relevance in recent years as benchmark covered bonds with sizes between 500 m and 1 bn have become much more common. Index providers have also adjusted their entry requirements to include covered bonds from 500 m upwards. On top of this, in some cases, bonds were allocated to this category merely on the basis of their nominal volume being larger than 1bn and not necessarily on the bonds fulfilling all of the typical jumbo covered bond criteria such as having at least three lead managers publicly placing the bonds. The jumbo bucket therefore in some cases made the true investable universe look much bigger than it actually was. By merging the two and by changing the definition of "public placement" to listed and syndicated, we hope that we have eliminated or at least substantially minimised both problems and provide a much more realistic picture.

For covered bonds that are issued in currencies other than EUR we have used the commonly accepted minimum sizes in local currency to distinguish between the categories and then used the EUR equivalent amount in our calculations. In USD for example, we are using USD 1 bn and USD 500 m as cut off volumes, in AUD it is AUD 1 bn and AUD 500 m while in the GBP market we used GBP 500 m and GBP 250 m.

We are aware that especially the size and placement type category changes are very substantial changes to how data is displayed. Backdating data to fit the new categories and maintain a consistent data history for previous years is a major challenge. Some countries managed to go through this exercise while others struggled. We therefore have a full dataset going back to 2003 for some countries while we only have 2012 data for others. Consequently on the aggregate covered bond market level, we can only show data for the new categorisation for 2012. We still decided to make the change and accept this flaw as the advantage of painting a more realistic picture of market realities weighs more in our view. The old categories together with the historic data can be found on the 2012 edition of the ECBC Fact Book.

We have tried in the past and will continue to try to improve the quality of the data even for previous years. When collecting data for the ECBC covered bond statistics, we use data that is publicly available (i.e., covered bond reports of the issuers such as ACT reports, information provided by the credit rating agencies such as Fitch, Moody's and S&P, data provided by Bloomberg and Reuters, and information provided by the supervisory authorities such as data on dedicated covered bond websites). In some cases the information provided by these databases differs. In some cases they also show bonds as outstanding that have actually already been bought back or cancelled by the issuer. In order to provide the most accurate possible statistics and to solve data differences across sources, we intensified our dialogue with the issuers for our 2012 data collection exercise. We informed issuers about existing discrepancies and kindly asked them to arrange for the necessary public domain updates. We then took care of the related update of our covered bond database. As a result of this, there are some slight differences in the numbers for 2011 compared to what was published last year. In our view, these adjustments are perfectly normal and we would rather adjust historic data to reflect a more realistic picture than mechanically hold on to data that was once published but proven incorrect.

Before going into the actual statistics, we want to make some general remarks about the figures which are necessary to interpret them correctly:

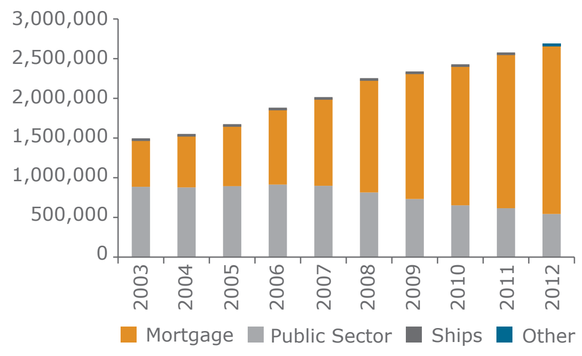
- Covered bonds are divided into those denominated in euro, those in domestic currency (if not the euro), and those in a currency other than the euro and the domestic currency. The exchange rate used to convert non-EUR-denominated bonds is the end-of-year rate published by the European Central Bank.
- For the purpose of counting the number of issuers and of new issuers the following applies. Issuers are entities with at least one outstanding covered bond at year-end. Issuers with multiple programmes still only count as one. The only exception to this rule is French covered bonds. In case of France, the actual issuer is a specialised bank rather than the mother company. As a result, one mother company with two covered bond programmes also counts as two issuers as the issuance actually comes from two separate legal entities. New issuers are entities with at least one outstanding covered bond at year-end, but with no outstanding covered bond at the prior year-end.
- Spain: Spain's covered bond statistics are based on the data provided by Spain's AIAF (Asociación de Intermediarios de Activos Financieros). We have complemented this with USD denominated Cédulas issued under Reg/S or 144a documentation that are not listed in the AIAF as well as registered unlisted covered bonds from the ECBC Covered Bond Label Database. The breakdown into public and private placements in Spain is entirely based on non-AIAF sources as the AIAF database does not systematically include this criterion. In the past, the number of issuers provided by AIAF included the new financial institutions established as part of the restructuring of the Spanish banking sector as well as all the former financial institutions with outstanding covered bonds at the end of 2011 - even if as a consequence of the aforementioned restructuring they were integrated into a new institution. Because of this the number of issuers had been going up rather than down which is what one would have expected. When adjusting for the merger activity, the number of issuers at the end of 2011 was 42 rather than 64. For this year, we have changed the way we calculate the number of Spanish issuers to only include those that are separate legal entities and disregard any previous entities that have by now been merged.
- Canada: Covered bonds backed by mortgages insured against borrower default by the Canada Mortgage and Housing Corporation are classed as mortgage covered bonds.
- Sweden: Sweden's covered bond statistics exclude retained transactions used for the purpose of accessing central bank liquidity, and include only converted bostadsobligationer (mortgage bonds) and säkerställda obligationer (covered bonds).

COVERED BOND MARKET DEVELOPMENTS IN 2012

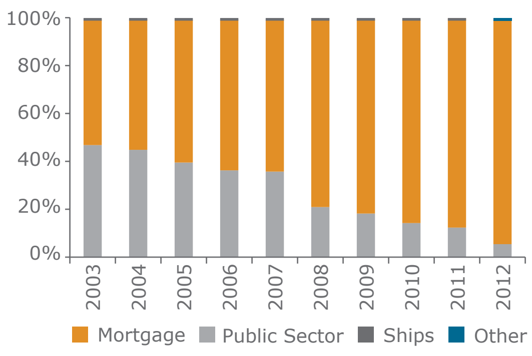
The covered bond market has continued to grow in 2012 albeit at a slower pace than the year before. Outstanding covered bonds worldwide grew by 5.2%to reach EUR 2.813 bn after EUR 2.674 bn in 2011. The market had still been growing by 6.8% in 2011. Bank deleveraging, stronger reliance on central bank funding and stable to shrinking asset markets in a number of countries all contributed to this slow down. What kept the market in growth territory was on the one hand a significant increase in the issuance activity of non European countries such as Australia or New Zealand. On the other hand banks especially from countries like Italy or Spain used newly issued and retained covered bonds as collateral for central bank repo operations. Overall new issuance increased slightly by 1.5% to EUR 707 bn.

Despite the fact that 2012 saw the first benchmark covered bond backed by aircraft mortgages and discussions about new collateral classes are taking place in a number of countries, 2012 also saw an even bigger focus by issuers on the most traditional of cover asset types – mortgages. Of the 2012 new issuance over 90% was backed by mortgage collateral (after 84% in 2011). Public sector backed covered bonds only made up 5% after they had still represented 12% in 2011 and over one third in 2007.

> FIGURE 1: COVERED BONDS OUTSTANDING (EURM)



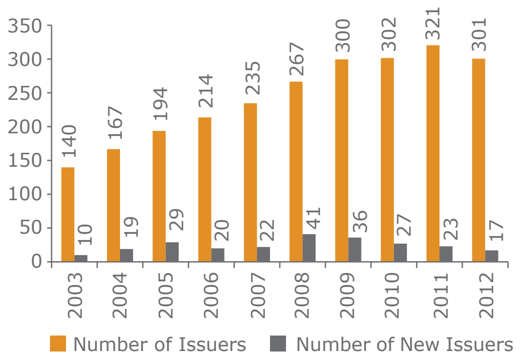
> FIGURE 2: BREAKDOWN OF NEW ISSUANCE 2012 BY COLLATERAL TYPE



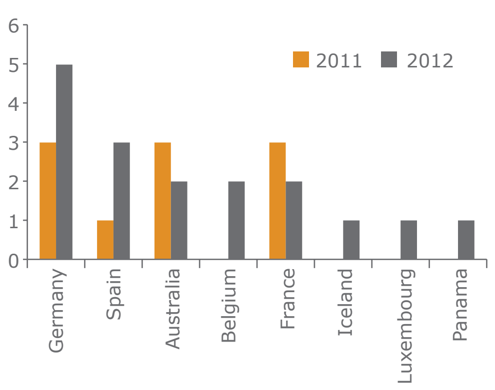
Source: ECBC, Crédit Agricole CIB

After both Belgium as well as Panama joined the market in 2012 and the last covered bonds from Latvia matured, at the end of the year, the market comprised a total of 29 different countries and a total of 306 issuers. In 2011 we still had covered bonds from 28 countries and 321 issuers. However it would be wrong to say that the covered bond family has ceased to grow in any meaningful way or even is on the retreat. The main reason for the drop in the number of issuers was above all the merger process in Spain (-4 issuers) combined with a change in the definition of the number of issuers in Spain (-23 issuers). At the same time, globally 20 new issuers started issuing covered bonds from countries ranging from Belgium to Panama and France to Australia and even in Spain we had 3 new issuers as the result of merger and restructuring activity.

> FIGURE 3: NUMBER OF EXISTING AND NEW COVERED BOND ISSUERS



> FIGURE 4: NEW ISSUERS 2012 BY COUNTRY

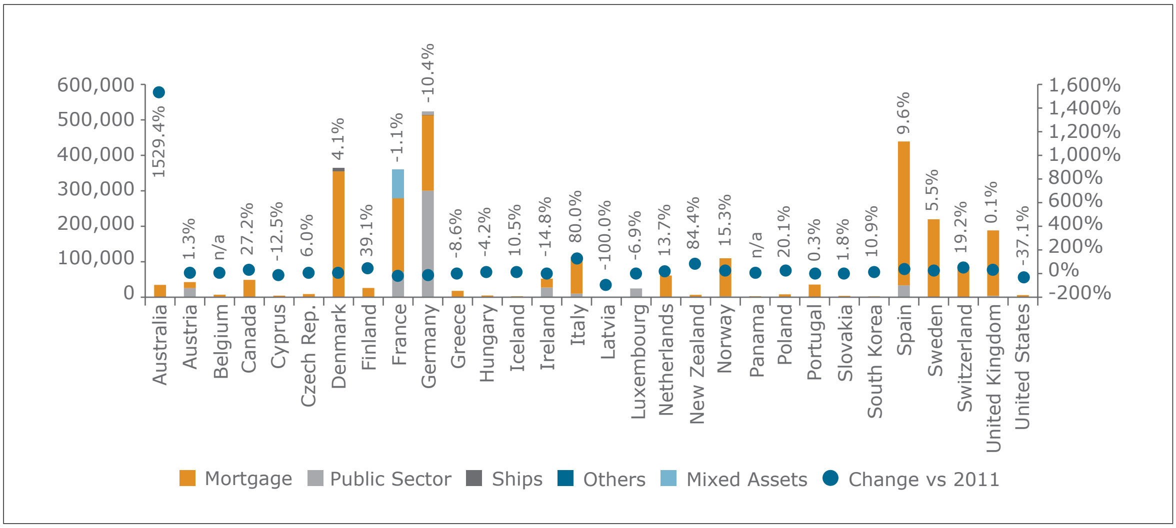


Source: ECBC, Crédit Agricole CIB

Despite shrinking by 10%, the Pfandbrief market is still the biggest sector amounting to EUR 525 bn or 19% of the overall covered bond market. Looking at the mortgage backed covered bonds only – the collateral type where the biggest issuance has been taking place in recent years – Spain is the biggest market with EUR 407 bn followed by Denmark with EUR 360 bn. The covered bond market is still a predominantly European one. Covered bonds issued by countries from outside of Europe such as Australia (EUR 35 bn), Canada (EUR 49 bn), New Zealand (EUR 7 bn) or South Korea (EUR 2 bn) only account for 3.5% of all covered bonds outstanding worldwide.

When looking at market dynamics, the picture changes though. The most dynamic markets can in fact be found outside of Europe. With regards to growth rates Australia leads the market by quite some distance growing its market size by more than factor 15 between 2011 and 2012 while covered bonds from New Zealand grew by 84%. Growth of many of the big European markets such as Germany or France stalled or even shrunk in the same period. Out of Europe, only Italian issuers had a growth rate similar to that of New Zealand for example, virtually doubling in market size.

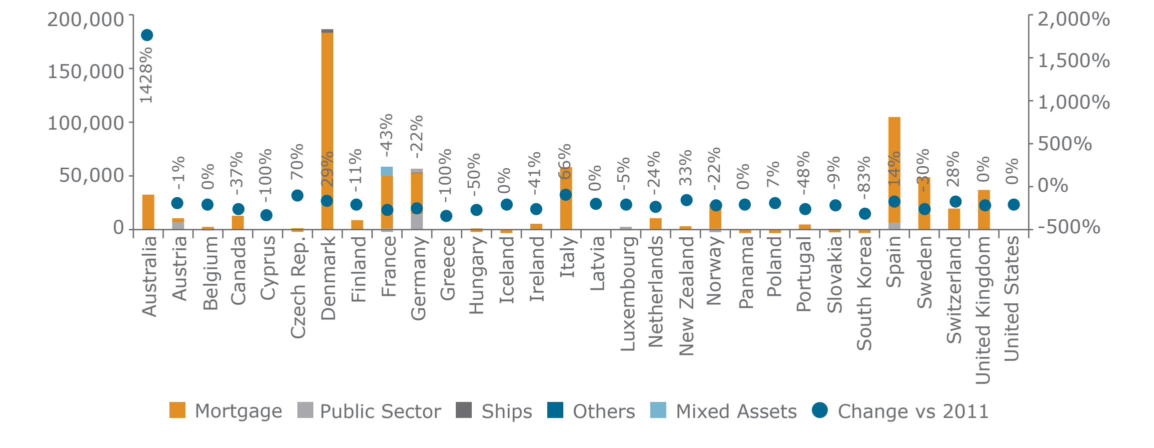
> Figure 5: 2012 outstanding covered bonds by country and collateral type (EURm) as well as change vs. 2011 (%)



Source: ECBC, Crédit Agricole CIB

Just focussing on the new issuance, the Danes are way ahead of everyone else despite the outstanding volume of Danish covered bonds only growing by 4%. Because of the way Danish issuers roll short dated covered bonds at regular auctions their issuance volumes are very high compared to other countries. Their EUR 187bn covered bond issuance in 2012 lead the market and are followed by EUR 105 bn out of Spain. German issuers come only fifth with EUR 57 bn slightly trailing Italian and French issuers which issued EUR 71 bn and EUR 58 bn of covered bonds in 2012 respectively.

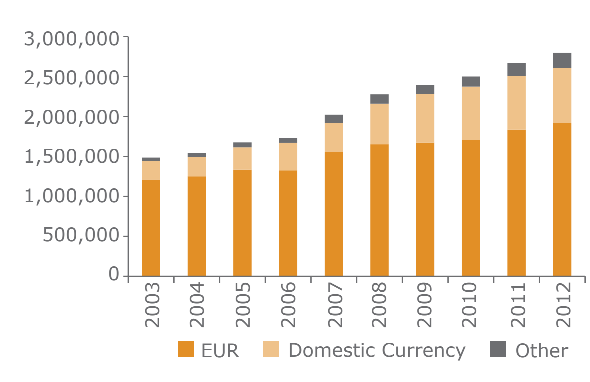
> Figure 6: 2012 covered bond new issuance by country and collateral type (EURm) as well as change vs. 2011 (%)



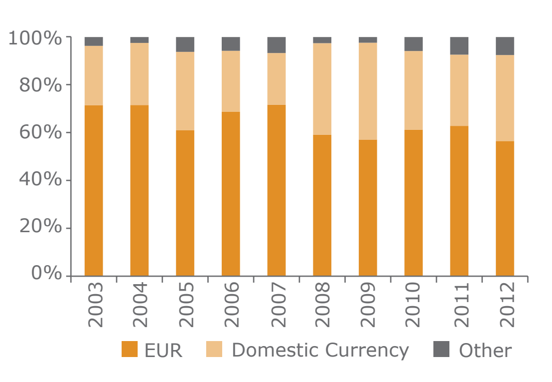
Source: ECBC, Crédit Agricole CIB

Covered bonds have become a global product with issuers from virtually all continents except for Africa being active in the market. The market is however still predominantly a European product and most of the outstanding issuance is in either EUR or in case of the Nordic markets their respective domestic currency.

> Figure 7: Outstanding covered bonds by currency (EURbn)



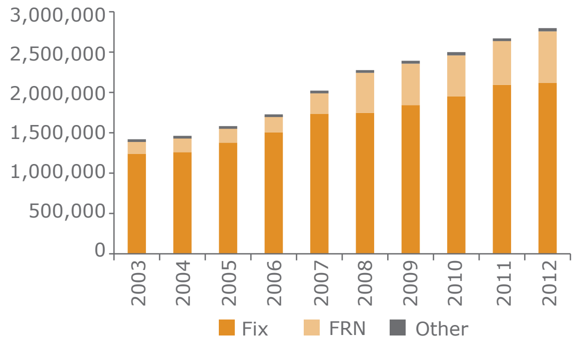
> Figure 8: New covered bond issuance by currency (%)



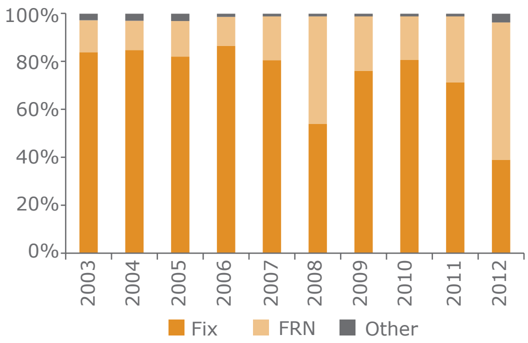
Source: ECBC, Crédit Agricole CIB

Looking at the split of outstanding covered bonds by interest rate type it becomes clear that the covered bond market is dominated by fixed rate covered bonds. Over 75% of the market is outstanding in this format. The low interest rate environment has not really changed much in this regards. If anything non-EUR markets show a bigger tendency towards FRN covered bonds. They have become a regular feature of USD and GBP markets for example. In EUR markets, the vast majority of FRN covered bonds are retained and used for ECB repo purposes as the floating rate coupon means they are treated as 0-1Y exposure and thus get the lowest possible haircuts.

> FIGURE 9: OUTSTANDING. COVERED BONDS BY INTEREST RATE TYPE (EURBN)



> FIGURE 10: NEW COVERED BOND ISSUANCE BY INTEREST RATE TYPE (%)



Source: ECBC, Crédit Agricole CIB

QUICK LOOK AHEAD INTO 2013

Many of the themes that were intact in 2012 still continue to be major factors in 2013. Issuance across the board from European issuers in H1 2013 is still muted, especially in public benchmark covered bond issues. Banks are still reducing balance sheet while there are still banks that continue to rely on central bank funding. At the same time banks outside of Europe are still active covered bond issuers and keep growing their respective markets. Since July this year, the first Canadian banks have restarted to issue and will therefore add a few additional billion to the 2013 statistics. Because of a change in their legal framework they had been absent from issuing for much of 2012 and early 2013.

Overall the globalisation of the product will continue with the first covered bond from Chile and potentially Singapore joining the covered bond club. However, before these new countries can add sizable volumes that drive the overall statistic, it will take a bit longer. In the meantime 2013 will probably be another slow year. Underlying economic conditions and cover asset markets in Europe will have to pick up speed again for covered bond issuance to show higher growth rates across the board.

5.2 STATISTICS

5.2.1 TOTAL

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total CB Outstanding										
Public Sector	886,979	879,320	894,944	915,003	899,500	815,550	733,076	653,022	616,551	543,977
Mortgage	601,413	665,071	772,081	959,070	1,113,474	1,447,968	1,647,606	1,835,691	2,044,555	2,255,357
Ships	10,087	9,542	10,586	11,341	12,167	16,327	15,151	14,527	12,640	13,571
Others	-	-	-	-	-	-	-	-	-	506
Total Outstanding	1,498,479	1,553,933	1,677,611	1,885,414	2,025,142	2,279,845	2,395,833	2,503,240	2,673,746	2,813,411

Public Placements										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,445,626
Benchmark (500 to 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	220,450
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	341,417
Private Placements	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	805,919
Sum	1,498,479	1,553,933	1,677,611	1,885,414	2,025,142	2,279,845	2,395,833	2,503,240	2,673,746	2,813,411

Denominated in Euro	1,212,927	1,252,336	1,336,837	1,327,303	1,556,456	1,653,746	1,675,800	1,705,653	1,837,619	1,930,894
Denominated in domestic currency	230,340	243,278	278,597	346,388	364,936	509,403	610,742	671,389	673,075	691,480
Denominated in other currencies	44,461	47,568	62,178	57,121	103,749	116,695	109,291	126,197	163,052	191,037
Sum	1,487,728	1,543,183	1,677,611	1,730,812	2,025,141	2,279,845	2,395,833	2,503,240	2,673,746	2,813,411

Outstanding fixed coupon	1,241,859	1,261,771	1,379,653	1,506,550	1,738,502	1,749,339	1,845,534	1,953,193	2,097,083	2,120,312
Outstanding floating coupon	155,423	177,148	178,093	203,957	255,658	498,255	514,376	509,402	544,289	652,968
Outstanding other	24,578	25,313	27,225	20,305	30,982	32,252	35,923	40,645	32,374	40,131
Sum	1,421,859	1,464,233	1,584,971	1,730,812	2,025,141	2,279,845	2,395,833	2,503,240	2,673,746	2,813,411

Number of Issuers	140	167	194	214	235	267	300	302	321	306

Issuance (in EUR million)										
Total Covered Bonds Issuance										
Public Sector	187,282	167,844	186,098	181,992	163,611	132,988	91,526	84,018	82,711	36,495
Mortgage	210,004	204,362	280,671	316,157	297,004	511,145	438,066	523,271	613,262	665,643
Ships	2,421	1,785	3,579	3,334	3,143	6,289	2,221	3,325	1,016	4,643
Others	-	-	-	-	-	-	-	-	-	506
Total Issuance	399,707	373,991	470,348	501,484	463,758	650,422	531,813	610,614	696,989	707,286

Public Placements										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	319,064
Benchmark (500 to 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	61,782
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	83,379
Private Placements	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	243,061
Sum	399,707	373,991	470,348	501,484	463,758	650,422	531,813	610,614	696,989	707,285

Denominated in Euro	283,572	267,724	284,635	344,682	332,468	384,906	303,839	373,830	438,040	405,271
Denominated in domestic currency	98,710	97,100	153,030	127,961	100,317	248,869	215,370	200,886	207,676	249,631
Denominated in other currencies	14,593	9,167	28,876	28,840	30,973	16,647	12,603	35,648	51,272	52,384
Sum	396,876	373,991	466,541	501,483	463,758	650,422	531,812	610,364	696,987	707,286

Issuance fixed coupon	319,503	309,890	375,583	397,601	373,852	350,869	405,130	492,617	497,484	271,042
Issuance floating coupon	50,741	44,735	67,913	55,813	85,232	292,374	122,152	115,649	196,586	410,994
Issuance other	10,403	10,765	13,977	6,035	4,673	7,179	4,530	2,348	2,918	25,250
Sum	380,647	365,391	457,473	459,449	463,757	650,422	531,812	610,614	696,988	707,286

Number of New Issuers	10	19	29	20	22	41	36	27	23	20

Please note that a few changes have been undertaken to the way data is grouped and shown compared to the previous years. A number of these changes, especially the size and placement type category changes, are substantial to how data is displayed. Backdating data to fit the new categories and maintain a consistent data history for previous years is a major challenge. Therefore, there is a full dataset going back to 2003 for some countries while there is only 2012 data for others. Consequently, on the aggregate covered bond market level, only data for the new categorisation for 2012 is shown. The old categories together with the historic data can be found on the 2012 edition of the ECBC Fact Book. For further information on these changes, please see the Statistics introduction on page 537. Finally, please note that the statistics contain "n.a." where data is not available and "-" when the value is zero.

5.2.2 TOTAL 2012 STATISTICS BY TYPE OF ASSETS

COVERED BONDS OUTSTANDING 2012 in EUR million						
	Public Sector	Mortgage	Ships	Others	Mixed Assets	TOTAL
Australia	-	34,902	-	-	-	34,902
Austria	25,831	17,010	-	-	-	42,841
Belgium	-	2,590	-	-	-	2,590
Canada	-	49,121	-	-	-	49,121
Cyprus	-	4,550	-	-	-	4,550
Czech Republic	-	9,056	-	-	-	9,056
Denmark	-	359,560	6,325	-	-	365,885
Finland	-	26,684	-	-	-	26,684
France	72,033	208,297	-	-	81,560	361,890
Germany	301,125	215,999	7,246	506	-	524,876
Greece	-	18,046	-	-	-	18,046
Hungary	-	4,958	-	-	-	4,958
Iceland	-	893	-	-	-	893
Ireland	27,546	25,099	-	-	-	52,645
Italy	10,300	116,405	-	-	-	126,705
Latvia	-	-	-	-	-	-
Luxembourg	24,859	-	-	-	-	24,859
The Netherlands	-	61,515	-	-	-	61,515
New Zealand	-	6,741	-	-	-	6,741
Norway	2,742	107,462	-	-	-	110,205
Panama	-	152	-	-	-	152
Poland	110	657	-	-	-	768
Portugal	1,300	34,570	-	-	-	35,870
Slovakia	-	3,835	-	-	-	3,835
South Korea	-	2,407	-	-	-	2,407
Spain	33,609	406,736	-	-	-	440,345
Sweden	-	220,374	-	-	-	220,374
Switzerland	-	85,714	-	-	-	85,714
United Kingdom	3,742	185,243	-	-	-	188,985
United States	-	6,000	-	-	-	6,000
Total	**503,197**	**2,214,577**	**13,571**	**506**	**81,560**	**2,813,411**

COVERED BONDS ISSUANCE 2012 in EUR million						
	Public Sector	Mortgage	Ships	Others	Mixed Assets	TOTAL
Australia	-	32,731	-	-	-	32,731
Austria	6,882	3,805	-	-	-	10,687
Belgium	-	2,590	-	-	-	2,590
Canada	-	12,941	-	-	-	12,941
Cyprus	-	-	-	-	-	-
Czech Republic	-	1,309	-	-	-	1,309
Denmark	-	185,845	1,474	-	-	187,319
Finland	-	9,368	-	-	-	9,368
France	1,150	49,260	-	-	8,101	58,511
Germany	14,341	38,540	3,169	506	-	56,556
Greece	-	-	-	-	-	-
Hungary	-	1,140	-	-	-	1,140
Iceland	-	113	-	-	-	113
Ireland	-	5,500	-	-	-	5,500
Italy	-	70,768	-	-	-	70,768
Latvia	-	-	-	-	-	-
Luxembourg	2,660	-	-	-	-	2,660
The Netherlands	-	10,738	-	-	-	10,738
New Zealand	-	3,192	-	-	-	3,192
Norway	943	22,946	-	-	-	23,888
Panama	-	152	-	-	-	152
Poland	61	228	-	-	-	289
Portugal	-	4,850	-	-	-	4,850
Slovakia	-	785	-	-	-	785
South Korea	-	178	-	-	-	178
Spain	6,407	98,846	-	-	-	105,253
Sweden	-	48,936	-	-	-	48,936
Switzerland	-	19,723	-	-	-	19,723
United Kingdom	-	37,109	-	-	-	37,109
United States	-	-	-	-	-	-
Total	**32,444**	**661,592**	**4,643**	**506**	**8,101**	**707,286**

Source: EMF/ECBC

5.2.3 AUSTRALIA

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	-	-	2,142	34,902
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	-	-	-	-	-	2,142	34,902
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	1,739	25,443
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	3,666
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	2,150
Private Placement	-	-	-	-	-	-	-	-	403	3,643
Sum	-	-	-	-	-	-	-	-	2,142	34,902
Denominated in EURO	-	-	-	-	-	-	-	-	-	10,242
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	9,676
Denominated in other currencies	-	-	-	-	-	-	-	-	2,142	14,984
Sum	-	-	-	-	-	-	-	-	2,142	34,902
Outstanding fixed coupon	-	-	-	-	-	-	-	-	2,142	27,640
Outstanding floating coupon	-	-	-	-	-	-	-	-	-	7,262
Outstanding other	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	-	-	-	-	-	2,142	34,902
Number of Issuers	-	-	-	-	-	-	-	-	3	5

Issuance (in EUR million)										
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	-	-	2,142	32,731
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	-	-	-	-	-	2,142	32,731
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	1,739	25,443
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	2,698
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	947
Private Placement	-	-	-	-	-	-	-	-	403	3,643
Sum	-	-	-	-	-	-	-	-	2,142	32,731
Denominated in EURO	-	-	-	-	-	-	-	-	-	10,242
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	9,676
Denominated in other currencies	-	-	-	-	-	-	-	-	2,142	12,813
Sum	-	-	-	-	-	-	-	-	2,142	32,731
Issuance fixed coupon	-	-	-	-	-	-	-	-	2,142	25,469
Issuance floating coupon	-	-	-	-	-	-	-	-	-	7,262
Issuance other	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	-	-	-	-	-	2,142	32,731
Number of New Issuers	-	-	-	-	-	-	-	-	3	2

5.2.4 AUSTRIA

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	6,750	6,750	13,038	15,615	15,200	17,326	19,617	19,555	25,116	25,831
Mortgage	4,000	4,000	4,000	3,880	4,125	4,973	5,317	7,645	17,174	17,010
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	10,750	10,750	17,038	19,495	19,325	22,299	24,934	27,200	42,290	42,841

Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	6,000	7,087
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	9,915	11,328
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	5,821	5,897
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	20,554	18,529
Sum	10,750	10,750	17,038	19,495	19,325	22,299	24,934	27,200	42,290	42,841

Denominated in EURO	n.a.	n.a.	15,691	17,703	17,304	19,664	24,002	21,510	37,576	39,068
Denominated in domestic currency	n.a.	n.a.	-	-	-	-	-	-	-	-
Denominated in other currencies	n.a.	n.a.	1,347	1,792	2,021	2,634	932	5,690	4,714	3,773
Sum	10,750	10,750	17,038	19,495	19,325	22,298	24,934	27,200	42,290	42,841

Outstanding fixed coupon	n.a.	n.a.	13,497	17,207	18,111	19,189	16,593	17,900	32,275	32,696
Outstanding floating coupon	n.a.	n.a.	3,324	2,062	1,029	3,110	6,309	6,600	7,650	7,750
Outstanding other	n.a.	n.a.	217	226	185	-	2,032	2,700	2,364	2,395
Sum	10,750	10,750	17,038	19,495	19,325	22,299	24,934	27,200	42,290	42,841

Number of Issuers	12	15	22	23	24	25	26	23	24	25

Issuance (in EUR million)										
Total Covered Bonds Issuance										
Public Sector	1,802	n.a.	3,591	3,110	3,131	9,361	2,501	8,125	7,114	6,882
Mortgage	1,029	n.a.	214	2,176	1,959	1,321	1,442	3,600	3,664	3,805
Ships	-	n.a.	-	-	-	-	-	-	-	-
Others	-	n.a.	-	-	-	-	-	-	-	-
Total Issuance	2,831	n.a.	3,805	5,286	5,090	10,682	3,943	11,725	10,778	10,687

Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	3,000	1,000
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	2,750	2,500
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	321	318
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	4,707	6,869
Sum	2,831	n.a.	3,805	5,286	5,090	10,682	3,943	11,725	10,778	10,687

Denominated in EURO	n.a.	n.a.	n.a.	4,899	4,861	10,362	3,943	10,725	10,008	10,447
Denominated in domestic currency	n.a.	n.a.	n.a.	-	-	-	-	-	-	-
Denominated in other currencies	n.a.	n.a.	n.a.	387	229	320	-	1,000	770	240
Sum	2,831	n.a.	3,805	5,286	5,090	10,682	3,943	11,725	10,778	10,687

Issuance fixed coupon	n.a.	n.a.	n.a.	3,807	4,577	8,255	3,252	10,200	5,922	8,155
Issuance floating coupon	n.a.	n.a.	n.a.	1,478	490	2,262	435	525	4,561	2,201
Issuance other	n.a.	n.a.	n.a.	-	23	165	256	1,000	295	331
Sum	2,831	n.a.	3,805	5,286	5,090	10,682	3,943	11,725	10,778	10,687

Number of New Issuers	1	3	7	1	1	1	1	2	1	1

5.2.5 BELGIUM

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	-	-	-	2,590
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	-	-	-	-	-	-	2,590
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	2,500
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	-	-	-	-	90
Sum	-	-	-	-	-	-	-	-	-	2,590
Denominated in EURO	-	-	-	-	-	-	-	-	-	2,590
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	-	-	-	-	-	-	2,590
Outstanding fixed coupon	-	-	-	-	-	-	-	-	-	2,590
Outstanding floating coupon	-	-	-	-	-	-	-	-	-	-
Outstanding other	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	-	-	-	-	-	-	2,590
Number of Issuers	-	-	-	-	-	-	-	-	-	2

Issuance (in EUR million)										
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	-	-	-	2,590
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	-	-	-	-	-	-	2,590
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	2,500
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	-	-	-	-	90
Sum	-	-	-	-	-	-	-	-	-	2,590
Denominated in EURO	-	-	-	-	-	-	-	-	-	2,590
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	-	-	-	-	-	-	2,590
Issuance fixed coupon	-	-	-	-	-	-	-	-	-	2,590
Issuance floating coupon	-	-	-	-	-	-	-	-	-	-
Issuance other	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	-	-	-	-	-	-	2,590
Number of New Issuers	-	-	-	-	-	-	-	-	-	2

5.2.6 CANADA

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	2,000	6,574	7,525	18,003	38,610	49,121
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	-	2,000	6,574	7,525	18,003	38,610	49,121
Public Placement										
Benchmark (1bn and above)	-	-	-	-	n.a.	6,280	6,238	14,600	34,009	43,495
Benchmark (500Mio - 999Mio)	-	-	-	-	n.a.		496	2,230	3,653	4,130
Others (below 500Mio)	-	-	-	-	n.a.	294	792	1,173	948	1,119
Private Placement	-	-	-	-	n.a.	-	-	-	-	378
Sum	-	-	-	-	2,000	6,574	7,525	18,003	38,610	49,121
Denominated in EURO	-	-	-	-	2,000	6,574	6,574	4,250	4,250	2,576
Denominated in domestic currency	-	-	-	-	-	-	496	1,201	2,043	2,055
Denominated in other currencies	-	-	-	-	-	-	455	12,552	32,317	44,490
Sum	-	-	-	-	2,000	6,574	7,525	18,003	38,610	49,121
Outstanding fixed coupon	-	-	-	-	2,000	6,250	6,999	17,763	38,610	48,743
Outstanding floating coupon	-	-	-	-	-	324	526	240	-	378
Outstanding other	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	-	2,000	6,574	7,525	18,003	38,610	49,121
Number of Issuers	-	-	-	-	1	3	3	5	7	7

Issuance (in EUR million)										
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	2,000	4,574	951	12,650	20,441	12,941
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	-	2,000	4,574	951	12,650	20,441	12,941
Public Placement										
Benchmark (1bn and above)	-	-	-	-	n.a.	4,280	-	10,334	19,036	11,942
Benchmark (500Mio - 999Mio)	-	-	-	-	n.a.	-	496	1,667	1,405	455
Others (below 500Mio)	-	-	-	-	n.a.	294	455	649	-	166
Private Placement	-	-	-	-	n.a.	-	-	-	-	378
Sum	-	-	-	-	2,000	4,574	951	12,650	20,441	12,941
Denominated in EURO	-	-	-	-	2,000	4,250	-	-	-	-
Denominated in domestic currency	-	-	-	-	-	-	496	638	832	-
Denominated in other currencies	-	-	-	-	-	324	455	12,012	19,608	12,941
Sum	-	-	-	-	2,000	4,574	951	12,650	20,440	12,941
Issuance fixed coupon	-	-	-	-	2,000	4,250	749	12,650	20,441	12,563
Issuance floating coupon	-	-	-	-	-	-	202	-	-	-
Issuance other	-	-	-	-	-	324	-	-	-	378
Sum	-	-	-	-	2,000	4,574	951	12,650	20,441	12,941
Number of New Issuers	-	-	-	-	1	2	-	2	2	-

5.2.7 CYPRUS

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	-	-	5,200	4,550
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	-	-	-	-	-	5,200	4,550
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	-	-	-	5,200	4,550
Sum	-	-	-	-	-	-	-	-	5,200	4,550
Denominated in EURO	-	-	-	-	-	-	-	-	5,200	4,550
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	-	-	-	-	-	5,200	4,550
Outstanding fixed coupon	-	-	-	-	-	-	-	-	-	-
Outstanding floating coupon	-	-	-	-	-	-	-	-	5,200	4,550
Outstanding other	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	-	-	-	-	-	5,200	4,550
Number of Issuers	-	-	-	-	-	-	-	-	2	2

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	-	-	5,200	-
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	-	-	-	-	-	5,200	-
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	-	-	-	5,200	-
Sum	-	-	-	-	-	-	-	-	5,200	-
Denominated in EURO	-	-	-	-	-	-	-	-	5,200	-
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	-	-	-	-	-	5,200	-
Issuance fixed coupon	-	-	-	-	-	-	-	-	-	-
Issuance floating coupon	-	-	-	-	-	-	-	-	5,200	-
Issuance other	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	-	-	-	-	-	5,200	-
Number of New Issuers	-	-	-	-	-	-	-	-	2	-

5.2.8 CZECH REPUBLIC

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	1,638	1,956	4,452	5,543	8,213	8,091	8,179	8,234	8,546	9,056
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	1,638	1,956	4,452	5,543	8,213	8,091	8,179	8,234	8,546	9,056
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	1,538	1,721	3,710	4,682	6,613	6,502	5,439	5,454	5,194	5,522
Private Placement	100	235	742	861	1,600	1,589	2,740	2,780	3,352	3,534
Sum	1,638	1,956	4,452	5,543	8,213	8,091	8,179	8,234	8,546	9,056
Denominated in EURO	-	-	-	42	39	35	119	128	111	571
Denominated in domestic currency	1,638	1,956	4,452	5,501	8,174	8,056	8,060	8,106	8,435	8,485
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Sum	1,638	1,956	4,452	5,543	8,213	8,091	8,179	8,234	8,546	9,056
Outstanding fixed coupon	1,572	1,796	3,619	4,615	5,871	5,752	3,756	3,608	3,740	3,280
Outstanding floating coupon	66	160	833	928	1,675	1,270	3,900	4,063	4,119	5,096
Outstanding other	-	-	-	-	667	1,069	523	563	687	680
Sum	1,638	1,956	4,452	5,543	8,213	8,091	8,179	8,234	8,546	9,056
Number of Issuers	5	5	8	8	9	8	8	8	8	8
Issuance (in EUR million)										
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	666	744	2,558	956	3,501	938	738	723	770	1,309
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	666	744	2,558	956	3,501	938	738	723	770	1,309
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	566	609	2,068	875	3,347	938	187	705	711	742
Private Placement	100	135	490	81	154	-	551	18	59	567
Sum	666	744	2,558	956	3,501	938	738	723	770	1,309
Denominated in EURO	-	-	-	42	-	-	89	18	-	500
Denominated in domestic currency	666	744	2,558	914	3,501	938	649	705	770	809
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Sum	666	744	2,558	956	3,501	938	738	723	770	1,309
Issuance fixed coupon	666	650	1,897	903	1,322	55	76	420	378	484
Issuance floating coupon	-	94	661	53	1,699	789	662	178	169	745
Issuance other	-	-	-	-	480	95	-	125	223	80
Sum	666	744	2,558	956	3,501	938	738	723	770	1,309
Number of New Issuers	1	-	3	-	1	-	-	-	-	-

5.2.9 DENMARK

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	204,695	216,133	246,411	260,367	244,696	255,140	319,434	332,505	345,529	359,560
Ships	6,915	6,330	6,915	6,672	7,754	7,045	7,197	6,722	5,999	6,325
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	211,610	222,463	253,326	267,039	252,450	262,185	326,631	339,227	351,528	365,885
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	231,421
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	52,156
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	80,692
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,616
Sum	211,610	222,463	253,326	267,039	252,450	262,185	326,631	339,227	351,528	365,885
Denominated in EURO	17,457	18,315	18,432	18,743	19,547	22,520	37,675	42,848	43,753	46,451
Denominated in domestic currency	194,153	204,148	234,894	248,296	232,903	238,324	287,317	294,019	302,938	312,065
Denominated in other currencies	-	-	-	-	-	1,341	1,639	2,360	4,837	7,368
Sum	211,610	222,463	253,326	267,039	252,450	262,185	326,631	339,227	351,528	365,885
Outstanding fixed coupon	193,578	202,936	209,667	208,623	178,953	184,636	254,894	267,075	275,092	285,754
Outstanding floating coupon	5,735	7,877	32,729	48,232	73,497	77,549	71,737	72,152	76,436	80,131
Outstanding other	12,297	11,650	10,930	10,184	-	-	-	-	-	-
Sum	211,610	222,463	253,326	267,039	252,450	262,185	326,631	339,227	351,528	365,885
Number of Issuers	8	8	8	8	9	9	9	9	9	9
Issuance (in EUR million)										
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	99,727	95,009	149,708	114,014	70,955	103,230	125,484	148,475	145,147	185,845
Ships	318	139	1,837	960	2,515	235	935	136	121	1,474
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	100,045	95,148	151,545	114,974	73,470	103,465	126,419	148,611	145,268	187,319
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	140,705
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	18,339
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	27,843
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	432
Sum	100,045	95,148	151,545	114,974	73,470	103,465	126,419	148,611	145,268	187,319
Denominated in EURO	8,455	5,556	8,850	8,844	14,415	13,186	22,255	24,833	25,415	25,074
Denominated in domestic currency	91,590	89,591	142,695	106,130	59,055	90,279	101,183	122,374	116,911	158,335
Denominated in other currencies	-	-	-	-	-	-	2,981	1,404	2,942	3,910
Sum	100,045	95,148	151,545	114,974	73,470	103,465	126,419	148,611	145,268	187,319
Issuance fixed coupon	97,916	91,267	123,590	93,771	50,757	89,888	122,851	133,846	128,195	-
Issuance floating coupon	2,128	3,881	27,955	21,203	22,713	13,577	3,568	14,765	17,073	163,680
Issuance other	-	-	-	-	-	-	-	-	-	23,638
Sum	100,044	95,148	151,545	114,974	73,470	103,465	126,419	148,611	145,268	187,319
Number of New Issuers	-	-	-	-	1	-	-	-	-	-

Note: Since a large share of Danish mortgage covered bonds are tap-issued over a period of typically 3 years, Benchmark (1bn and above) issues and outstanding are defined as covered bond with more than EUR 1 bn in the year, the bond reach EUR 1 bn. The same way, Benchmark (500Mio - 999Mio) issues and outstanding are defined as covered bond with 500Mio - 999Mio euro in the year, the bond reach EUR 500 Mio, and at the same time does not exceed EUR 999 Mio. The definition includes both covered bonds denominated in DKK and in EUR. Danish covered bonds denominated in euro and issued in a jurisdiction outside Denmark are included in the Danish data.

5.2.10 FINLAND

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	250	1,500	3,000	4,500	5,750	7,625	10,125	18,839	26,684
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	250	1,500	3,000	4,500	5,750	7,625	10,125	18,839	26,684
Public Placement										
Benchmark (1bn and above)	-	-	1,000	2,000	3,000	4,000	5,250	7,250	14,750	20,750
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	600	1,600	2,200	2,200
Others (below 500Mio)	-	250	500	1,000	1,500	1,750	1,775	1,275	1,606	2,874
Private Placement	-	-	-	-	-	-	-	-	283	861
Sum	-	250	1,500	3,000	4,500	5,750	7,625	10,125	18,839	26,684
Denominated in EURO	-	250	1,500	3,000	4,500	5,750	7,625	10,125	18,453	26,114
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	386	571
Sum	-	250	1,500	3,000	4,500	5,750	7,625	10,125	18,839	26,684
Outstanding fixed coupon	-	-	1,000	2,250	3,750	4,750	6,500	9,250	17,863	23,247
Outstanding floating coupon	-	250	500	750	750	1,000	1,125	875	976	3,437
Outstanding other	-	-	-	-	-	-	-	-	-	-
Sum	-	250	1,500	3,000	4,500	5,750	7,625	10,125	18,839	26,684
Number of Issuers	-	1	2	2	3	3	3	4	4	5

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	250	1,250	1,500	1,500	1,250	2,125	5,250	9,964	9,368
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	250	1,250	1,500	1,500	1,250	2,125	5,250	9,964	9,368
Public Placement										
Benchmark (1bn and above)	-	-	1,000	1,000	1,000	1,000	1,250	4,000	8,500	7,000
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	600	1,000	600	-
Others (below 500Mio)	-	250	250	500	500	250	275	250	581	1,790
Private Placement	-	-	-	-	-	-	-	-	283	578
Sum	-	250	1,250	1,500	1,500	1,250	2,125	5,250	9,964	9,368
Denominated in EURO	-	250	1,250	1,500	1,500	1,250	2,125	5,250	9,578	9,186
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	386	182
Sum	-	250	1,250	1,500	1,500	1,250	2,125	5,250	9,964	9,368
Issuance fixed coupon	-	-	1,000	1,250	1,500	1,000	2,000	5,000	9,613	6,783
Issuance floating coupon	-	250	250	250	-	250	125	250	351	2,585
Issuance other	-	-	-	-	-	-	-	-	-	-
Sum	-	250	1,250	1,500	1,500	1,250	2,125	5,250	9,964	9,368
Number of New Issuers	-	1	1	-	1	-	-	1	-	1

5.2.11 FRANCE

Outstanding (in EUR million)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Total Covered Bonds Outstanding										
Public Sector	31,340	37,600	42,600	49,660	56,403	64,756	71,905	75,548	77,835	72,033
Mortgage	21,079	26,816	32,133	43,012	63,555	119,092	134,757	156,239	198,395	208,297
Mixed Assets	34,530	41,350	50,040	61,930	80,097	80,631	82,572	88,693	89,768	81,560
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	86,949	105,766	124,773	154,602	200,055	264,479	289,234	320,480	365,998	361,890
Public Placement										
Benchmark (Above 1bn)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	241,775
Benchmark (500Mio - 1bn)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	4,949
Others	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	36,595
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	78,570
Sum	86,949	105,766	124,773	154,602	200,055	264,479	289,234	320,480	365,998	361,890
Denominated in EURO	77,109	94,104	109,236	n.a.	165,779	226,922	256,798	285,501	327,874	331,212
Denominated in domestic currency	-	-	-	n.a.	-	-	-	-	-	-
Denominated in other currencies	9,840	11,662	15,537	n.a.	34,276	37,558	32,436	34,979	38,123	30,678
Sum	86,949	105,766	124,773	154,602	200,055	264,480	289,234	320,480	365,998	361,890
Outstanding fixed coupon	n.a.	n.a.	n.a.	n.a.	174,388	204,729	236,106	266,080	284,266	297,009
Outstanding floating coupon	n.a.	n.a.	n.a.	n.a.	10,502	48,633	42,600	43,710	75,068	47,805
Outstanding other	n.a.	n.a.	n.a.	n.a.	15,165	11,117	10,528	10,690	6,665	17,076
Sum	86,949	105,766	124,773	154,602	200,055	264,479	289,234	320,480	365,998	361,890
Number of Issuers	5	5	5	6	7	10	14	16	19	20
Issuance (in EUR million)										
Total Covered Bonds Issuance										
Public Sector	6,500	8,600	9,070	12,134	15,271	11,354	13,915	12,508	8,851	1,150
Mortgage	6,181	5,737	6,397	12,637	21,670	59,734	29,373	42,895	84,416	49,260
Mixed Assets	9,600	11,150	13,150	17,263	23,682	8,549	15,824	17,261	8,719	8,101
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	22,281	25,487	28,617	42,034	60,623	79,637	59,112	72,664	101,986	58,511
Public Placement										
Benchmark (Above 1bn)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	25,672
Benchmark (500Mio - 1bn)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,185
Others	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	4,830
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	26,824
Sum	22,281	25,487	28,617	42,034	60,623	79,637	59,112	72,664	101,986	58,511
Denominated in EURO	19,774	21,369	20,637	34,172	50,700	73,930	56,155	64,375	96,020	55,851
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	2,507	4,119	7,980	7,862	9,923	5,708	2,957	8,289	5,967	2,660
Sum	22,281	25,488	28,617	42,034	60,623	79,637	59,112	72,664	101,986	58,511
Issuance fixed coupon	n.a.	n.a.	n.a.	n.a.	57,009	37,158	50,443	64,503	67,612	36,003
Issuance floating coupon	n.a.	n.a.	n.a.	n.a.	2,614	42,224	8,519	7,953	34,286	22,368
Issuance other	n.a.	n.a.	n.a.	n.a.	1,000	255	150	208	89	140
Sum	22,281	25,488	28,617	42,034	60,623	79,637	59,112	72,664	101,986	58,511
Number of New Issuers	-	-	-	1	1	3	4	4	3	1

Note: The "Mixed assets" category refers to covered bonds that are backed by a mix of public sector assets, mortgage loans. The bonds (outstanding and issuance) have been allocated equally between mortgage and public sector categories in the total (5.2.1 section of the Fact Book).

5.2.12 GERMANY

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	797,492	760,264	734,713	720,835	677,656	578,974	486,406	412,090	355,673	301,125
Mortgage	256,027	246,636	237,547	223,306	206,489	217,367	225,100	219,947	223,676	215,999
Ships	3,172	3,212	3,670	4,669	4,413	9,282	7,954	7,805	6,641	7,246
Others	-	-	-	-	-	-	-	-	-	506
Total Outstanding	1,056,691	1,010,112	975,930	948,810	888,558	805,623	719,460	639,842	585,990	524,876
Public Placement										
Benchmark (1bn and above)	383,219	366,719	354,592	326,140	298,220	266,747	224,042	170,068	141,393	112,869
Benchmark (500Mio - 999Mio)	30,276	28,740	27,740	31,102	36,178	32,909	27,683	28,644	28,704	36,862
Others (below 500Mio)	258,596	181,004	185,578	155,379	92,675	62,805	66,030	46,344	43,634	75,244
Private Placement	384,600	433,649	408,020	436,189	461,485	443,162	401,705	394,786	372,259	299,901
Sum	1,056,691	1,010,112	975,930	948,810	888,558	805,623	719,460	639,842	585,990	524,876
Denominated in EURO	1,030,959	985,370	952,485	922,878	863,594	778,623	690,510	620,420	565,529	506,639
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	25,732	24,742	23,445	25,932	24,964	27,000	28,950	19,422	20,461	18,237
Sum	1,056,691	1,010,112	975,930	948,810	888,558	805,623	719,460	639,842	585,990	524,876
Outstanding fixed coupon	901,004	838,345	845,386	823,130	789,338	689,124	619,364	546,791	493,983	433,787
Outstanding floating coupon	144,270	160,693	120,681	121,754	90,552	107,522	90,136	78,105	74,340	76,840
Outstanding other	11,417	11,075	9,863	3,926	8,668	8,976	9,959	14,946	17,667	14,249
Sum	1,056,691	1,010,112	975,930	948,810	888,558	805,623	719,460	639,842	585,990	524,876
Number of Issuers	41	48	54	57	58	59	61	63	66	70

Issuance (in EUR million)										
Total Covered Bonds Issuance										
Public Sector	151,690	131,506	137,235	129,452	107,913	89,522	52,251	41,574	30,990	14,341
Mortgage	57,621	40,773	33,722	35,336	26,834	57,345	56,852	42,216	40,911	38,540
Ships	2,103	1,646	1,742	2,374	628	6,054	1,286	3,189	895	3,169
Others	-	-	-	-	-	-	-	-	-	506
Total Issuance	211,414	173,925	172,699	167,162	135,375	152,921	110,389	86,979	72,796	56,556
Public Placement										
Benchmark (1bn and above)	39,265	42,325	48,450	45,210	32,980	26,285	17,125	16,853	21,406	4,008
Benchmark (500Mio - 999Mio)	10,460	4,250	9,050	7,200	12,556	10,880	7,650	10,297	5,319	11,879
Others (below 500Mio)	89,233	62,848	49,395	24,525	12,437	30,172	18,732	11,835	15,632	11,816
Private Placement	72,456	64,502	65,804	90,227	77,402	85,584	66,882	47,994	30,439	28,853
Sum	211,414	173,925	172,699	167,162	135,375	152,921	110,389	86,979	72,796	56,556
Denominated in EURO	203,206	172,085	163,931	159,340	131,807	149,137	107,488	84,459	68,585	52,608
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	8,208	1,840	8,768	7,822	3,568	3,784	2,901	2,520	4,211	3,948
Sum	211,414	173,925	172,699	167,162	135,375	152,921	110,389	86,979	72,796	56,556
Issuance fixed coupon	155,531	130,723	138,259	143,869	113,085	111,309	89,605	62,518	54,023	32,274
Issuance floating coupon	45,685	36,559	27,077	18,859	20,099	40,156	20,091	23,468	16,692	23,702
Issuance other	10,198	6,643	7,363	4,434	2,191	1,456	693	993	2,081	580
Sum	211,414	173,925	172,699	167,162	135,375	152,921	110,389	86,979	72,796	56,556
Number of New Issuers	3	7	6	4	2	4	5	5	3	5

5.2.13 GREECE

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	5,000	6,500	19,750	19,750	18,046
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	-	-	5,000	6,500	19,750	19,750	18,046
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	1,500	1,500	1,500	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	846
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	5,000	5,000	18,250	18,250	17,200
Sum	-	-	-	-	-	5,000	6,500	19,750	19,750	18,046
Denominated in EURO	-	-	-	-	-	5,000	6,500	19,750	19,750	18,046
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	-	-	5,000	6,500	19,750	19,750	18,046
Outstanding fixed coupon	-	-	-	-	-	-	1,500	1,500	1,500	846
Outstanding floating coupon	-	-	-	-	-	5,000	5,000	18,250	18,250	17,200
Outstanding other	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	-	-	5,000	6,500	19,750	19,750	18,046
Number of Issuers	-	-	-	-	-	3	3	4	4	4

Issuance (in EUR million)										
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	5,000	1,500	17,250	5,000	-
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	-	-	5,000	1,500	17,250	5,000	-
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	1,500	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	5,000	-	17,250	5,000	-
Sum	-	-	-	-	-	5,000	1,500	17,250	5,000	-
Denominated in EURO	-	-	-	-	-	5,000	1,500	17,250	5,000	-
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	-	-	5,000	1,500	17,250	5,000	-
Issuance fixed coupon	-	-	-	-	-	-	1,500	-	-	-
Issuance floating coupon	-	-	-	-	-	5,000	-	17,250	5,000	-
Issuance other	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	-	-	5,000	1,500	17,250	5,000	-
Number of New Issuers	-	-	-	-	-	3	-	2	1	-

5.2.14 HUNGARY

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	3,568	4,962	5,072	5,924	5,987	7,105	7,375	6,323	5,175	4,958
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	3,568	4,962	5,072	5,924	5,987	7,105	7,375	6,323	5,175	4,958
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	2,290
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	865
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,803
Sum	3,568	4,962	5,072	5,924	5,987	7,105	7,375	6,323	5,175	4,958
Denominated in EURO	-	350	540	1,547	1,784	2,879	3,799	2,904	2,167	1,863
Denominated in domestic currency	3,568	4,612	4,532	4,377	4,203	4,209	3,559	3,419	2,934	3,059
Denominated in other currencies	-	-	-	-	-	17	17		74	36
Sum	3,568	4,962	5,072	5,924	5,987	7,105	7,375	6,323	5,175	4,958
Outstanding fixed coupon	3,182	4,556	4,587	5,214	5,080	4,086	6,737	5,713	3,195	3,318
Outstanding floating coupon	297	316	398	635	907	3,019	638	610	1,980	1,640
Outstanding other	89	90	87	75	-	-	-	-	-	-
Sum	3,568	4,962	5,072	5,924	5,987	7,105	7,375	6,323	5,175	4,958
Number of Issuers	3	3	3	3	3	3	3	3	3	3

Issuance (in EUR million)										
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	2,961	2,381	808	1,418	331	3,331	3,209	542	2,264	1,140
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	2,961	2,381	808	1,418	331	3,331	3,209	542	2,264	1,140
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	510
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	630
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-
Sum	2,961	2,381	808	1,418	331	3,331	3,209	542	2,264	1,140
Denominated in EURO	-	350	190	1,007	291	1,407	1,102	300	1,600	510
Denominated in domestic currency	2,961	2,031	618	411	40	1,907	2,107	242	565	630
Denominated in other currencies	-	-	-	-	-	17	-	-	99	-
Sum	2,961	2,381	808	1,418	331	3,331	3,209	542	2,264	1,140
Issuance fixed coupon	2,779	2,377	718	1,168	116	2,275	3,200	477	538	630
Issuance floating coupon	177	-	90	250	215	1,056	9	65	1,726	510
Issuance other	4	4	-	-	-	-	-	-	-	-
Sum	2,961	2,381	808	1,418	331	3,331	3,209	542	2,264	1,140
Number of New Issuers	-	-	-	-	-	-	-	-	-	-

5.2.15 ICELAND

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	467	478	492	685	807	808	893
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	467	478	492	685	807	808	893
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	467	478	492	685	807	808	893
Private Placement	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	467	478	492	685	807	808	893
Denominated in EURO	-	-	-	-	-	-	-	-	-	-
Denominated in domestic currency	-	-	-	467	478	492	685	807	808	893
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	467	478	492	685	807	808	893
Outstanding fixed coupon	-	-	-	-	-	-	-	-	-	15
Outstanding floating coupon	-	-	-	-	-	-	-	-	-	-
Outstanding other	-	-	-	467	478	492	685	807	808	878
Sum	-	-	-	467	478	492	685	807	808	893
Number of Issuers	-	-	-	2	2	1	1	1	1	2

Issuance (in EUR million)										
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	467	-	321	-	-	-	113
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	467	-	321	-	-	-	113
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	467	-	321	-	-	-	113
Private Placement	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	467	-	321	-	-	-	113
Denominated in EURO	-	-	-	-	-	-	-	-	-	-
Denominated in domestic currency	-	-	-	467	-	321	-	-	-	113
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	467	-	321	-	-	-	113
Issuance fixed coupon	-	-	-	-	-	-	-	-	-	15
Issuance floating coupon	-	-	-	-	-	-	-	-	-	-
Issuance other	-	-	-	467	-	321	-	-	-	98
Sum	-	-	-	467	-	321	-	-	-	113
Number of New Issuers	-	-	-	2	-	-	-	-	-	1

5.2.16 IRELAND

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	12,362	27,204	40,965	49,914	51,204	52,613	50,951	36,492	31,760	27,546
Mortgage	-	2,000	4,140	11,900	13,575	23,075	29,725	29,037	30,007	25,099
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	12,362	29,204	45,105	61,814	64,779	75,688	80,676	65,529	61,767	52,645
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	26,402	23,079
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	500	500
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,092	868
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	33,773	28,198
Sum	12,362	29,204	45,105	61,814	64,779	75,688	80,676	65,529	61,767	52,645
Denominated in EURO	10,881	26,696	37,452	52,800	52,328	60,056	67,626	54,940	53,054	44,725
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	1,481	2,508	7,654	9,014	12,451	15,632	13,050	10,589	8,713	7,920
Sum	12,362	29,204	45,105	61,814	64,779	75,688	80,676	65,529	61,767	52,645
Outstanding fixed coupon	12,027	28,460	40,717	55,832	56,094	48,817	43,717	40,069	35,853	32,658
Outstanding floating coupon	335	631	2,095	3,028	5,299	23,294	33,607	22,507	22,919	17,008
Outstanding other	-	114	2,294	2,954	3,386	3,577	3,353	2,953	2,995	2,979
Sum	12,362	29,204	45,105	61,814	64,779	75,688	80,676	65,529	61,767	52,645
Number of Issuers	2	3	3	4	4	5	6	6	6	5

Issuance (in EUR million)										
Total Covered Bonds Issuance										
Public Sector	12,362	15,047	13,576	9,722	9,533	12,665	3,174	60	-	-
Mortgage	-	2,000	2,000	7,753	1,675	9,506	14,801	6,000	9,290	5,500
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	12,362	17,047	15,576	17,475	11,208	22,171	17,975	6,060	9,290	5,500
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,000
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	500
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	4,000
Sum	12,362	17,047	15,576	17,475	11,208	22,171	17,975	6,060	9,290	5,500
Denominated in EURO	10,881	15,816	10,663	15,035	6,612	18,741	17,975	6,060	9,290	5,500
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	1,481	1,231	4,914	2,440	4,596	3,430	-	-	-	-
Sum	12,362	17,047	15,576	17,475	11,208	22,171	17,975	6,060	9,290	5,500
Issuance fixed coupon	12,027	16,467	12,033	15,537	8,183	4,600	4,175	210	-	1,500
Issuance floating coupon	335	466	1,445	1,101	2,351	17,240	13,750	5,850	9,290	4,000
Issuance other	-	114	2,097	837	674	331	50	-	-	-
Sum	12,362	17,047	15,576	17,475	11,208	22,171	17,975	6,060	9,290	5,500
Number of New Issuers	2	1	-	1	-	1	1	-	-	-

5.2.17 ITALY

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	-	-	4,000	8,063	8,063	8,063	9,063	10,092	12,999	10,300
Mortgage	-	-	-	-	-	6,500	14,000	26,925	50,768	116,405
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	4,000	8,063	8,063	14,563	23,063	37,017	63,767	126,705
Public Placement										
Benchmark (1bn and above)	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	37,927
Benchmark (500Mio - 999Mio)	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	4,450
Others (below 500Mio)	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,783
Private Placement	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	82,544
Sum	-	-	4,000	8,063	8,063	14,563	23,063	37,017	63,767	126,705
Denominated in EURO	-	-	4,000	8,000	8,000	14,500	23,000	36,925	63,668	126,705
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	63	63	63	63	92	99	-
Sum	-	-	4,000	8,063	8,063	14,563	23,063	37,017	63,767	126,705
Outstanding fixed coupon	-	-	4,000	8,063	8,063	10,063	15,563	27,100	44,954	50,059
Outstanding floating coupon	-	-	-	-	-	500	500	2,825	18,814	76,646
Outstanding other	-	-	-	-	-	4,000	7,000	7,092	-	-
Sum	-	-	4,000	8,063	8,063	14,563	23,063	37,017	63,767	126,705
Number of Issuers	-	-	1	1	1	4	7	11	12	14

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Issuance										
Public Sector	-	-	4,000	4,063	-	-	3,000	2,000	5,900	-
Mortgage	-	-	-	-	-	6,500	7,500	12,925	29,261	70,768
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	4,000	4,063	-	6,500	10,500	14,925	35,161	70,768
Public Placement										
Benchmark (1bn and above)	-	-	n.a.	n.a.	-	n.a.	n.a.	n.a.	n.a.	6,304
Benchmark (500Mio - 999Mio)	-	-	n.a.	n.a.	-	n.a.	n.a.	n.a.	n.a.	1,700
Others (below 500Mio)	-	-	n.a.	n.a.	-	n.a.	n.a.	n.a.	n.a.	-
Private Placement	-	-	n.a.	n.a.	-	n.a.	n.a.	n.a.	n.a.	62,764
Sum	-	-	4,000	4,063	-	6,500	10,500	14,925	35,161	70,768
Denominated in EURO	-	-	4,000	4,000	-	6,500	10,500	14,925	35,161	70,768
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	63	-	-	-	-	-	-
Sum	-	-	4,000	4,063	-	6,500	10,500	14,925	35,161	70,768
Issuance fixed coupon	-	-	4,000	4,000	-	2,000	7,500	12,600	18,750	11,013
Issuance floating coupon	-	-	-	-	-	500	-	2,325	16,411	59,755
Issuance other	-	-	-	63	-	4,000	3,000	-	-	-
Sum	-	-	4,000	4,063	-	6,500	10,500	14,925	35,161	70,768
Number of New Issuers	-	-	-	-	-	3	3	4	1	2

5.2.18 LATVIA

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	35	54	60	63	90	90	85	63	37	-
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	35	54	60	63	90	90	85	63	37	-
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	35	54	60	63	90	90	85	63	37	-
Private Placement	-	-	-	-	-	-	-	-	-	-
Sum	35	54	60	63	90	90	85	63	37	-
Denominated in EURO	-	-	-	20	56	69	64	45	25	-
Denominated in domestic currency	35	36	38	34	28	17	17	14	12	-
Denominated in other currencies	-	18	21	8	6	4	4	4		
Sum	35	54	60	63	90	90	85	63	37	-
Outstanding fixed coupon	26	27	26	21	15	26	26	27	12	-
Outstanding floating coupon	9	27	34	41	75	64	59	36	25	-
Outstanding other	-	-	-	-	-	-	-	-	-	-
Sum	35	54	60	63	90	90	85	63	37	-
Number of Issuers	1	1	1	4	5	5	5	4	2	-
Issuance (in EUR million)										
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	11	22	4	20	19	25	-	-	-	-
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	11	22	4	20	19	25	-	-	-	-
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	11	22	4	20	19	25	-	-	-	-
Private Placement	-	-	-	-	-	-	-	-	-	-
Sum	11	22	4	20	19	25	-	-	-	-
Denominated in EURO	-	-	-	20	19	25	-	-	-	-
Denominated in domestic currency	11	3	4	-	-	-	-	-	-	-
Denominated in other currencies		18		-	-	-	-	-	-	-
Sum	11	22	4	20	19	25	-	-	-	-
Issuance fixed coupon	9	3	-	-	-	25	-	-	-	-
Issuance floating coupon	2	18	4	20	19	-	-	-	-	-
Issuance other	-	-	-	-	-	-	-	-	-	-
Sum	11	22	4	20	19	25	-	-	-	-
Number of New Issuers	-	-	-	3	1	-	-	-	-	-

5.2.19 LUXEMBOURG

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	16,870	19,627	24,968	28,360	33,741	35,467	31,645	28,889	26,700	24,859
Mortgage	-	-	-	150	150	150	-	-	-	-
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	16,870	19,627	24,968	28,510	33,891	35,617	31,645	28,889	26,700	24,859
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,768
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	9,696
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	13,395
Sum	16,870	19,627	24,968	28,510	33,891	35,617	31,645	28,889	26,700	24,859
Denominated in EURO	9,473	11,032	10,909	12,319	16,172	18,147	16,592	15,826	15,496	14,994
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	7,397	8,595	14,059	16,191	17,719	17,470	15,053	13,063	11,204	9,864
Sum	16,870	19,627	24,968	28,510	33,891	35,617	31,645	28,889	26,700	24,859
Outstanding fixed coupon	11,631	12,236	15,427	19,077	22,573	22,267	21,126	20,390	16,547	14,766
Outstanding floating coupon	4,465	5,489	7,376	7,217	9,210	11,270	9,355	7,710	9,377	8,507
Outstanding other	774	1,902	2,165	2,216	2,108	2,080	1,164	789	776	1,585
Sum	16,870	19,627	24,968	28,510	33,891	35,617	31,645	28,889	26,700	24,859
Number of Issuers	3	3	3	3	5	5	5	5	5	6

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Issuance										
Public Sector	4,528	5,516	9,611	9,730	10,052	3,967	3,083	3,524	2,788	2,660
Mortgage	-	-	-	150	-	-	-	-	-	-
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	4,528	5,516	9,611	9,880	10,052	3,967	3,083	3,524	2,788	2,660
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	2,660
Sum	4,528	5,516	9,611	9,880	10,052	3,967	3,083	3,524	2,788	2,660
Denominated in EURO	2,131	3,589	2,468	3,628	5,773	2,639	2,661	3,260	2,422	2,587
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	2,397	1,927	7,143	6,252	4,279	1,328	422	264	366	73
Sum	4,528	5,516	9,611	9,880	10,052	3,967	3,083	3,524	2,788	2,660
Issuance fixed coupon	2,828	3,516	7,511	8,092	5,425	1,423	1,526	1,213	336	187
Issuance floating coupon	1,500	1,600	1,700	1,601	4,448	2,471	1,530	2,289	2,452	2,473
Issuance other	200	400	400	187	178	73	27	22	-	-
Sum	4,528	5,516	9,611	9,880	10,051	3,967	3,083	3,524	2,788	2,660
Number of New Issuers	-	-	-	-	2	-	-	-	-	1

5.2.20 THE NETHERLANDS

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	2,000	8,132	15,973	21,667	29,057	41,273	54,115	61,515
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	2,000	8,132	15,973	21,667	29,057	41,273	54,115	61,515
Public Placement										
Benchmark (1bn and above)	-	-	2,000	5,500	11,000	14,275	20,650	29,150	38,850	44,487
Benchmark (500Mio - 999Mio)	-	-	-	-	604	1,208	1,209	2,083	2,081	2,086
Others (below 500Mio)	-	-	-	1,127	2,188	3,752	3,457	3,752	4,080	5,216
Private Placement	-	-	-	1,505	2,181	2,432	3,742	6,288	9,105	9,726
Sum	-	-	2,000	8,132	15,973	21,667	29,057	41,273	54,115	61,515
Denominated in EURO	-	-	2,000	7,092	14,657	19,847	27,215	37,947	49,908	55,578
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	1,040	1,316	1,819	1,842	3,326	4,206	5,938
Sum	-	-	2,000	8,132	15,973	21,667	29,057	41,273	54,115	61,515
Outstanding fixed coupon	-	-	2,000	7,852	14,377	18,487	26,240	38,667	52,634	59,855
Outstanding floating coupon	-	-	-	240	1,536	3,120	2,757	2,546	1,421	1,601
Outstanding other	-	-	-	40	60	60	60	60	60	60
Sum	-	-	2,000	8,132	15,973	21,667	29,057	41,273	54,115	61,515
Number of Issuers	-	-	1	1	2	5	5	5	5	5

Issuance (in EUR million)										
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	2,000	6,132	7,873	5,608	7,725	13,710	14,163	10,738
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	2,000	6,132	7,873	5,608	7,725	13,710	14,163	10,738
Public Placement										
Benchmark (1bn and above)	-	-	2,000	3,500	5,500	3,000	6,250	9,750	8,250	8,387
Benchmark (500Mio - 999Mio)	-	-	-	-	-	535	-	748	1,000	-
Others (below 500Mio)	-	-	-	1,127	1,697	1,823	165	666	1,937	1,310
Private Placement	-	-	-	1,505	676	251	1,310	2,547	2,977	1,041
Sum	-	-	2,000	6,132	7,873	5,608	7,725	13,710	14,163	10,738
Denominated in EURO	-	-	2,000	5,092	7,565	5,191	7,725	12,387	13,207	8,859
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	1,040	308	418	-	1,324	957	1,879
Sum	-	-	2,000	6,132	7,873	5,608	7,725	13,710	14,163	10,738
Issuance fixed coupon	-	-	2,000	5,852	6,539	4,033	7,725	13,633	14,033	10,558
Issuance floating coupon	-	-	-	240	1,314	1,575	-	77	130	180
Issuance other	-	-	-	40	20	-	-	-	-	-
Sum	-	-	2,000	6,132	7,873	5,608	7,725	13,710	14,163	10,738
Number of New Issuers	-	-	1	-	1	3	-	-	-	-

5.2.21 NEW ZEALAND

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	-	1,247	3,656	6,741
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	-	-	-	-	1,247	3,656	6,741
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	1,000	2,000	2,000
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	1,050	2,801
Others (below 500Mio)	-	-	-	-	-	-	-	247	606	1,099
Private Placement	-	-	-	-	-	-	-	-	-	841
Sum	-	-	-	-	-	-	-	1,247	3,656	6,741
Denominated in EURO	-	-	-	-	-	-	-	1,000	2,500	4,500
Denominated in domestic currency	-	-	-	-	-	-	-	247	606	841
Denominated in other currencies	-	-	-	-	-	-	-	-	550	1,400
Sum	-	-	-	-	-	-	-	1,247	3,656	6,741
Outstanding fixed coupon	-	-	-	-	-	-	-	1,247	3,477	6,119
Outstanding floating coupon	-	-	-	-	-	-	-	-	179	622
Outstanding other	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	-	-	-	-	1,247	3,656	6,741
Number of Issuers	-	-	-	-	-	-	-	1	4	4

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	-	1,247	2,409	3,192
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	-	-	-	-	1,247	2,409	3,192
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	1,000	1,000	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	1,050	1,750
Others (below 500Mio)	-	-	-	-	-	-	-	247	358	1,099
Private Placement	-	-	-	-	-	-	-	-	-	343
Sum	-	-	-	-	-	-	-	1,247	2,409	3,192
Denominated in EURO	-	-	-	-	-	-	-	1,000	1,500	2,000
Denominated in domestic currency	-	-	-	-	-	-	-	247	358	343
Denominated in other currencies	-	-	-	-	-	-	-	-	550	849
Sum	-	-	-	-	-	-	-	1,247	2,409	3,192
Issuance fixed coupon	-	-	-	-	-	-	-	1,247	2,229	2,757
Issuance floating coupon	-	-	-	-	-	-	-	-	179	435
Issuance other	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	-	-	-	-	1,247	2,409	3,192
Number of New Issuers	-	-	-	-	-	-	-	1	3	-

5.2.22 NORWAY

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	751	1,837	3,759	2,742
Mortgage	-	-	-	-	6,371	21,924	53,582	70,401	91,852	107,462
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	-	6,371	21,924	54,333	72,238	95,611	110,205
Public Placement										
Benchmark (1bn and above)	-	-	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	51,179
Benchmark (500Mio - 999Mio)	-	-	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	20,125
Others (below 500Mio)	-	-	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	32,574
Private Placement	-	-	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	6,327
Sum	-	-	-	-	6,371	21,924	54,333	72,238	95,611	110,205
Denominated in EURO	-	-	-	-	4,500	12,847	14,522	22,022	29,953	38,597
Denominated in domestic currency	-	-	-	-	1,433	8,351	39,022	45,803	55,325	59,753
Denominated in other currencies	-	-	-	-	438	725	789	4,413	10,333	11,855
Sum	-	-	-	-	6,371	21,924	54,333	72,238	95,611	110,205
Outstanding fixed coupon	-	-	-	-	5,718	14,750	17,064	28,809	44,813	56,915
Outstanding floating coupon	-	-	-	-	653	7,174	37,269	43,429	50,798	53,290
Outstanding other	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	-	6,371	21,924	54,333	72,238	95,611	110,205
Number of Issuers	-	-	-	-	3	7	22	22	23	22

Issuance (in EUR million)										
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	751	1,421	2,374	943
Mortgage	-	-	-	-	6,458	15,660	30,105	21,062	28,135	22,946
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	-	6,458	15,660	30,856	22,483	30,509	23,888
Public Placement										
Benchmark (1bn and above)	-	-	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	10,916
Benchmark (500Mio - 999Mio)	-	-	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	4,748
Others (below 500Mio)	-	-	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	7,664
Private Placement	-	-	-	-	n.a.	n.a.	n.a.	n.a.	n.a.	560
Sum	-	-	-	-	6,458	15,660	30,856	22,483	30,509	23,888
Denominated in EURO	-	-	-	-	4,500	8,346	2,044	11,232	8,800	12,431
Denominated in domestic currency	-	-	-	-	1,521	7,042	28,745	7,777	15,808	9,463
Denominated in other currencies	-	-	-	-	438	272	67	3,474	5,901	1,994
Sum	-	-	-	-	6,458	15,660	30,856	22,483	30,509	23,888
Issuance fixed coupon	-	-	-	-	5,754	9,020	2,207	16,074	15,961	15,462
Issuance floating coupon	-	-	-	-	704	6,640	28,649	6,409	14,548	8,427
Issuance other	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	-	6,458	15,660	30,856	22,483	30,509	23,888
Number of New Issuers	-	-	-	-	3	4	15	-	1	-

5.2.23 PANAMA

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	-	-	-	152
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	-	-	-	-	-	-	152
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	152
Private Placement	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	-	-	-	-	-	-	152
Denominated in EURO	-	-	-	-	-	-	-	-	-	-
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	152
Sum	-	-	-	-	-	-	-	-	-	152
Outstanding fixed coupon	-	-	-	-	-	-	-	-	-	152
Outstanding floating coupon	-	-	-	-	-	-	-	-	-	-
Outstanding other	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	-	-	-	-	-	-	152
Number of Issuers	-	-	-	-	-	-	-	-	-	1

Issuance (in EUR million)										
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	-	-	-	152
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	-	-	-	-	-	-	152
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	152
Private Placement	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	-	-	-	-	-	-	152
Denominated in EURO	-	-	-	-	-	-	-	-	-	-
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	152
Sum	-	-	-	-	-	-	-	-	-	152
Issuance fixed coupon	-	-	-	-	-	-	-	-	-	152
Issuance floating coupon	-	-	-	-	-	-	-	-	-	-
Issuance other	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	-	-	-	-	-	-	152
Number of New Issuers	-	-	-	-	-	-	-	-	-	1

5.2.24 POLAND

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	131	137	139	126	112	110
Mortgage	160	220	558	453	676	561	583	511	527	657
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	160	220	558	453	807	698	722	636	639	768
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	768
Sum	160	220	558	453	807	698	722	636	639	768
Denominated in EURO	37	62	62	62	56	56	4	-	-	20
Denominated in domestic currency	111	115	440	357	726	617	711	636	639	748
Denominated in other currencies	11	43	56	34	25	25	7	-	-	-
Sum	159	220	558	453	807	698	722	636	639	768
Outstanding fixed coupon	4	4	4	4	1	1	4	-	-	-
Outstanding floating coupon	156	216	554	450	806	697	718	636	639	768
Outstanding other	-	-	-	-	-	-	-	-	-	-
Sum	160	220	558	453	807	698	722	636	639	768
Number of Issuers	1	1	2	2	2	3	3	3	2	2
Issuance (in EUR million)										
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	131	24	-	25	-	61
Mortgage	123	63	224	52	206	197	88	138	269	228
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	123	63	224	52	337	222	88	164	269	289
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	289
Sum	123	63	224	52	337	222	88	164	269	289
Denominated in EURO	23	25	-	-	-	-	-	-	-	20
Denominated in domestic currency	100	7	211	52	337	222	88	164	269	269
Denominated in other currencies		31	12	-	-	-	-	-	-	-
Sum	123	63	223	52	337	222	88	164	269	289
Issuance fixed coupon	-	-	-	-	-	-	-	-	-	-
Issuance floating coupon	123	63	224	52	337	222	88	164	269	289
Issuance other	-	-	-	-	-	-	-	-	-	-
Sum	123	63	224	52	337	222	88	164	269	289
Number of New Issuers	-	-	1	-	-	1	-	-	-	-

5.2.25 PORTUGAL

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	150	1,150	1,400	1,400	1,300
Mortgage	-	-	-	2,000	7,850	14,870	22,120	28,840	34,347	34,570
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	2,000	7,850	15,020	23,270	30,240	35,747	35,870
Public Placement										
Benchmark (1bn and above)	-	-	-	2,000	6,500	12,150	18,150	17,900	15,358	8,183
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	2,449
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	1,350	2,870	5,120	12,340	20,389	25,238
Sum	-	-	-	2,000	7,850	15,020	23,270	30,240	35,747	35,870
Denominated in EURO	-	-	-	2,000	7,850	15,020	23,270	30,240	35,747	35,870
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	2,000	7,850	15,020	23,270	30,240	35,747	35,870
Outstanding fixed coupon	-	-	-	2,000	6,500	12,170	18,170	17,960	15,418	10,691
Outstanding floating coupon	-	-	-	-	1,350	2,850	5,100	12,280	20,329	25,179
Outstanding other	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	2,000	7,850	15,020	23,270	30,240	35,747	35,870
Number of Issuers	-	-	-	1	2	5	6	7	9	9

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	150	1,000	250	-	-
Mortgage	-	-	-	2,000	5,850	7,020	7,250	11,870	9,300	4,850
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	2,000	5,850	7,170	8,250	12,120	9,300	4,850
Public Placement										
Benchmark (1bn and above)	-	-	-	2,000	4,500	5,650	6,000	3,000	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	1,350	1,520	2,250	9,120	9,300	4,850
Sum	-	-	-	2,000	5,850	7,170	8,250	12,120	9,300	4,850
Denominated in EURO	-	-	-	2,000	5,850	7,170	8,250	12,120	9,300	4,850
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	2,000	5,850	7,170	8,250	12,120	9,300	4,850
Issuance fixed coupon	-	-	-	2,000	4,500	5,650	6,000	3,040	-	-
Issuance floating coupon	-	-	-	-	1,350	1,520	2,250	9,080	9,300	4,850
Issuance other	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	2,000	5,850	7,170	8,250	12,120	9,300	4,850
Number of New Issuers	-	-	-	1	1	3	1	1	2	-

5.2.26 SLOVAK REPUBLIC

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	510	1,052	1,583	2,214	2,738	3,576	3,608	3,442	3,768	3,835
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	510	1,052	1,583	2,214	2,738	3,576	3,608	3,442	3,768	3,835
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,606
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	2,229
Sum	510	1,052	1,583	2,214	2,738	3,576	3,608	3,442	3,768	3,835
Denominated in EURO	-	-	-	280	510	1,189	3,516	3,350	3,625	3,680
Denominated in domestic currency	510	1,052	1,583	1,934	2,161	2,296	-	-	-	-
Denominated in other currencies	-	-	-	-	68	92	92	92	143	155
Sum	510	1,052	1,583	2,214	2,738	3,576	3,608	3,442	3,768	3,835
Outstanding fixed coupon	510	1,052	1,223	1,405	1,666	1,992	1,845	1,571	1,886	2,224
Outstanding floating coupon	-	-	360	809	1,073	1,584	1,762	1,871	1,882	1,606
Outstanding other	-	-	-	-	-	-	-	-	-	5
Sum	510	1,052	1,583	2,214	2,738	3,576	3,608	3,442	3,768	3,835
Number of Issuers	6	8	9	9	8	8	8	8	8	8

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	355	549	584	676	803	1,414	707	1,179	867	785
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	355	549	584	676	803	1,414	707	1,179	867	785
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	248
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	537
Sum	355	549	584	676	803	1,414	707	1,179	867	785
Denominated in EURO	-	-	-	280	230	679	707	1,179	820	735
Denominated in domestic currency	355	549	584	396	505	711	-	-	-	-
Denominated in other currencies	-	-	-	-	68	24	-	-	47	50
Sum	355	549	584	676	803	1,414	707	1,179	867	785
Issuance fixed coupon	355	549	223	227	539	902	529	349	414	703
Issuance floating coupon	-	-	360	449	264	512	178	830	452	77
Issuance other	-	-	-	-	-	-	-	-	-	5
Sum	355	549	584	676	803	1,414	707	1,179	867	785
Number of New Issuers	-	2	1	-	-	-	-	-	-	-

5.2.27 SOUTH KOREA

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	773	1,120	2,171	2,407
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	-	-	-	773	1,120	2,171	2,407
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	773	773	773	758
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	347	721	758
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	-	-	-	677	891
Sum	-	-	-	-	-	-	773	1,120	2,171	2,407
Denominated in EURO	-	-	-	-	-	-	-	-	-	-
Denominated in domestic currency	-	-	-	-	-	-	-	-	527	740
Denominated in other currencies	-	-	-	-	-	-	773	1,120	1,644	1,667
Sum	-	-	-	-	-	-	773	1,120	2,171	2,407
Outstanding fixed coupon	-	-	-	-	-	-	773	1,120	2,021	2,255
Outstanding floating coupon	-	-	-	-	-	-	-	-	150	152
Outstanding other	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	-	-	-	773	1,120	2,171	2,407
Number of Issuers	-	-	-	-	-	-	1	2	2	2
Issuance (in EUR million)										
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	-	-	-	773	347	1,051	178
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	-	-	-	773	347	1,051	178
Public Placement										
Benchmark (1bn and above)	-	-	-	-	-	-	773	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	347	374	-
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	-	-	-	677	178
Sum	-	-	-	-	-	-	773	347	1,051	178
Denominated in EURO	-	-	-	-	-	-	-	-	-	-
Denominated in domestic currency	-	-	-	-	-	-	-	-	527	178
Denominated in other currencies	-	-	-	-	-	-	773	347	524	-
Sum	-	-	-	-	-	-	773	347	1,051	178
Issuance fixed coupon	-	-	-	-	-	-	773	347	901	178
Issuance floating coupon	-	-	-	-	-	-	-	-	150	-
Issuance other	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	-	-	-	773	347	1,051	178
Number of New Issuers	-	-	-	-	-	-	1	1	-	-

5.2.28 SPAIN

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	4,900	7,200	9,640	11,590	17,054	17,749	16,724	19,098	32,657	33,609
Mortgage	57,111	94,707	150,213	214,768	266,959	315,055	336,750	343,401	369,208	406,736
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	62,011	101,907	159,853	226,358	284,013	332,804	353,474	362,499	401,865	440,345
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	243,207
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	11,850
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	200
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	185,088
Sum	62,011	101,907	159,853	226,358	284,013	332,804	353,474	362,499	401,865	440,345
Denominated in EURO	62,011	101,907	159,853	226,358	283,334	332,085	352,780	361,751	401,092	438,641
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	679	719	694	748	773	1,703
Sum	62,011	101,907	159,853	226,358	284,013	332,804	353,474	362,499	401,865	440,345
Outstanding fixed coupon	61,921	100,417	153,588	212,878	238,952	262,198	291,929	310,499	343,067	311,719
Outstanding floating coupon	90	1,490	6,265	13,480	45,061	70,606	61,545	52,000	58,797	128,625
Outstanding other	-	-	-	-	-	-	-	-	-	-
Sum	62,011	101,907	159,853	226,358	284,013	332,804	353,474	362,499	401,865	440,345
Number of Issuers	50	61	65	67	69	66	68	59	64	38
Issuance (in EUR million)										
Total Covered Bonds Issuance										
Public Sector	5,600	1,600	2,440	5,150	5,739	1,670	500	5,900	20,334	6,407
Mortgage	28,502	37,835	57,780	69,890	51,801	54,187	43,580	51,916	72,077	98,846
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	34,102	39,435	60,220	75,040	57,540	55,857	44,080	57,816	92,411	105,253
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	7,200
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	3,600
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	94,453
Sum	34,102	39,435	60,220	75,040	57,540	55,857	44,080	57,816	92,411	105,253
Denominated in EURO	34,102	39,435	60,220	75,040	56,861	55,857	44,080	57,816	92,411	105,253
Denominated in domestic currency	-	-	-	-	-	-	-	-	-	-
Denominated in other currencies	-	-	-	-	679	-	-	-	-	-
Sum	34,102	39,435	60,220	75,040	57,540	55,857	44,080	57,816	92,411	105,253
Issuance fixed coupon	33,312	38,635	55,545	66,125	36,549	21,957	37,480	50,891	52,507	27,559
Issuance floating coupon	790	800	4,675	8,915	20,991	33,900	6,600	6,925	39,904	77,694
Issuance other	-	-	-	-	-	-	-	-	-	-
Sum	34,102	39,435	60,220	75,040	57,540	55,857	44,080	57,816	92,411	105,253
Number of New Issuers	1	3	7	1	1	1	1	2	1	3

Source: AIAF, Bloomberg, Reuters, Moody's, ECB, ECBC.

Note: Please note that the breakdown public vs private placements is an estimation made by the ECBC.

Please also note that the methodology used for counting the number of issuers has changed this year. Until 2011, the number of new issuers included the new financial institutions established as part of the restructuring of the Spanish banking sector whose inaugural issue occurred during the year of reporting. The number of issuers also included all the former financial institutions with outstanding covered bonds at the end of each year - even if, as a consequence of the aforementioned restructuring, they were integrated into a new one - along with the new institutions. For 2012, however, only the new entities have been reported as active issuers.

5.2.29 SWEDEN

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	n.a.	n.a.	n.a.	-	-	-	-	-	-	-
Mortgage	n.a.	n.a.	n.a.	55,267	92,254	117,628	133,903	188,750	208,894	220,374
Ships	n.a.	n.a.	n.a.	-	-	-	-	-	-	-
Others	n.a.	n.a.	n.a.	-	-	-	-	-	-	-
Total Outstanding	n.a.	n.a.	n.a.	55,267	92,254	117,628	133,903	188,750	208,894	220,374
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	175,163
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	8,234
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	29,055
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	7,921
Sum	n.a.	n.a.	n.a.	55,267	92,254	117,628	133,903	188,750	208,894	220,374
Denominated in EURO	n.a.	n.a.	n.a.	5,283	13,171	21,126	25,787	35,697	37,554	39,995
Denominated in domestic currency	n.a.	n.a.	n.a.	49,474	77,436	93,374	103,809	144,969	159,628	164,501
Denominated in other currencies	n.a.	n.a.	n.a.	510	1,648	3,128	4,308	8,085	11,712	15,878
Sum	n.a.	n.a.	n.a.	55,267	92,254	117,628	133,903	188,750	208,894	220,374
Outstanding fixed coupon	n.a.	n.a.	n.a.	55,029	88,944	112,648	126,116	172,693	191,013	198,372
Outstanding floating coupon	n.a.	n.a.	n.a.	21	3,046	4,259	7,169	16,013	17,659	21,778
Outstanding other	n.a.	n.a.	n.a.	217	265	721	619	45	222	224
Sum	n.a.	n.a.	n.a.	55,267	92,254	117,628	133,903	188,750	208,894	220,374
Number of Issuers	n.a.	n.a.	n.a.	3	6	7	7	7	7	7

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Issuance										
Public Sector	n.a.	n.a.	n.a.	-	-	-	-	-	-	-
Mortgage	n.a.	n.a.	n.a.	17,569	36,638	43,488	53,106	79,910	69,800	48,936
Ships	n.a.	n.a.	n.a.	-	-	-	-	-	-	-
Others	n.a.	n.a.	n.a.	-	-	-	-	-	-	-
Total Issuance	n.a.	n.a.	n.a.	17,569	36,638	43,488	53,106	79,910	69,800	48,936
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	37,148
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	92
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	10,078
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1,620
Sum	n.a.	n.a.	n.a.	17,569	36,638	43,488	53,106	79,910	69,800	48,936
Denominated in EURO	n.a.	n.a.	n.a.	5,283	7,085	10,975	6,705	20,797	13,263	2,485
Denominated in domestic currency	n.a.	n.a.	n.a.	11,794	28,417	31,490	44,354	55,117	52,118	41,971
Denominated in other currencies	n.a.	n.a.	n.a.	492	1,135	1,023	2,047	3,997	4,419	4,481
Sum	n.a.	n.a.	n.a.	17,569	36,638	43,488	53,106	79,910	69,800	48,936
Issuance fixed coupon	n.a.	n.a.	n.a.	17,560	35,779	39,135	47,375	68,023	53,137	38,294
Issuance floating coupon	n.a.	n.a.	n.a.	2	752	4,353	5,376	11,888	16,562	10,642
Issuance other	n.a.	n.a.	n.a.	7	107	-	354	-	102	-
Sum	n.a.	n.a.	n.a.	17,569	36,638	43,488	53,106	79,910	69,800	48,936
Number of New Issuers	n.a.	n.a.	n.a.	3	3	1	-	-	-	-

5.2.30 SWITZERLAND

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Outstanding CBs - Pfandbriefe	30,326	29,941	29,010	29,395	29,013	36,180	43,283	58,046	60,729	67,652
Outstanding CBs - Structured	-	-	-	-	-	-	3,000	4,000	11,152	18,062
Total Outstanding	30,326	29,941	29,010	29,395	29,013	36,180	46,283	62,046	71,881	85,714
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	17,926
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	23,839
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	35,986
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	7,963
Sum	30,326	29,941	29,010	29,395	29,013	36,180	46,283	62,046	71,881	85,714
Denominated in EURO	-	-	-	-	-	-	3,000	7,000	10,250	13,000
Denominated in domestic currency	30,326	29,941	29,010	29,395	29,013	36,180	43,283	55,046	60,729	67,652
Denominated in other currencies	-	-	-	-	-	-	-	-	902	5,063
Sum	30,326	29,941	29,010	29,395	29,013	36,180	46,283	62,046	71,881	85,714
Outstanding fixed coupon	30,326	29,941	29,010	29,395	29,013	36,180	46,283	62,046	71,752	85,714
Outstanding floating coupon	-	-	-	-	-	-	-	-	-	-
Outstanding other	-	-	-	-	-	-	-	-	129	-
Sum	30,326	29,941	29,010	29,395	29,013	36,180	46,283	62,046	71,881	85,714
Number of Issuers	2	2	2	2	2	2	3	4	4	4

Issuance (in EUR million)										
Total Covered Bonds Issuance										
New Issues of CBs - Pfandbriefe	3,027	2,755	4,171	4,967	4,559	5,316	9,414	10,834	11,227	12,804
New Issues of CBs - Structured	-	-	-	-	-	-	3,000	4,000	4,152	6,919
Total Issuance	3,027	2,755	4,171	4,967	4,559	5,316	12,414	14,834	15,379	19,723
Public Placement										
Benchmark (1bn and above)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	6,919
Benchmark (500Mio - 999Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	2,394
Others (below 500Mio)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	10,410
Private Placement	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-
Sum	3,027	2,755	4,171	4,967	4,559	5,316	12,414	14,834	15,379	19,723
Denominated in EURO	-	-	-	-	-	-	3,000	4,000	3,250	2,750
Denominated in domestic currency	3,027	2,755	4,171	4,967	4,559	5,316	9,414	10,834	11,227	12,804
Denominated in other currencies	-	-	-	-	-	-	-	-	902	4,169
Sum	3,027	2,755	4,171	4,967	4,559	5,316	12,414	14,834	15,379	19,723
Issuance fixed coupon	3,027	2,755	4,171	4,967	4,559	5,316	12,414	14,834	15,250	19,723
Issuance floating coupon	-	-	-	-	-	-	-	-	-	-
Issuance other	-	-	-	-	-	-	-	-	129	-
Sum	3,027	2,755	4,171	4,967	4,559	5,316	12,414	14,834	15,379	19,723
Number of New Issuers	-	-	-	-	-	-	1	1	-	-

Note: from 2008 only Limmat bonds are considered as "Private Placements"

5.2.31 UNITED KINGDOM

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Regulated - Mortgages	-	-	-	-	-	125,764	109,473	125,250	121,623	147,425
Regulated - Public Sector	-	-	-	-	-	-	-	-	-	-
Non-regulated - Mortgages	5,000	15,668	28,384	54,265	84,874	78,092	90,993	77,965	63,429	37,818
Non-regulated - Public Sector	-	-	-	-	-	-	3,439	3,548	3,656	3,742
Total Outstanding	5,000	15,668	28,384	54,265	84,874	203,856	203,905	206,763	188,707	188,985
Public Placement										
Benchmark (1bn and above)	5,000	14,250	23,250	45,269	72,274	179,076	174,036	171,202	147,473	148,608
Benchmark (500Mio - 999Mio)	-	1,418	3,709	6,602	8,909	19,789	24,555	27,738	29,424	27,127
Others (below 500Mio)	-	-	1,425	2,395	3,691	4,981	5,304	6,643	9,231	9,137
Private Placement	-	-	-	-	-	10	10	1,180	2,580	4,113
Sum	5,000	15,668	28,384	54,265	84,874	203,856	203,905	206,763	188,707	188,985
Denominated in EURO	5,000	14,250	24,676	45,176	69,776	79,338	73,324	81,475	102,084	118,667
Denominated in domestic currency	-	1,418	3,648	6,552	7,023	116,049	122,395	115,625	76,905	61,012
Denominated in other currencies	-	-	60	2,536	8,075	8,469	8,186	9,663	9,718	9,306
Sum	5,000	15,668	28,384	54,265	84,874	203,856	203,905	206,763	188,707	188,985
Outstanding fixed coupon	5,000	15,668	25,439	49,956	76,236	78,287	71,342	83,820	111,426	123,888
Outstanding floating coupon	-	-	2,945	4,309	8,638	125,410	132,563	122,943	77,282	65,097
Outstanding other	-	-	-	-	-	160	-	-	-	-
Sum	5,000	15,668	28,384	54,265	84,874	203,856	203,905	206,763	188,707	188,985
Number of Issuers	1	3	5	7	8	19	21	20	16	15

Issuance (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Issuance										
Regulated - Mortgages	-	-	-	-	-	10,145	8,254	25,000	36,983	37,109
Regulated - Public Sector	-	-	-	-	-	-	-	-	-	-
Non-regulated - Mortgages	5,000	10,668	12,675	25,813	31,673	110,761	22,177	900	-	-
Non-regulated - Public Sector	-	-	-	-	-	-	3,439	-	-	-
Total Issuance	5,000	10,668	12,675	25,813	31,673	120,906	33,870	25,900	36,983	37,109
Public Placement										
Benchmark (1bn and above)	5,000	9,250	9,000	22,019	27,165	106,620	27,407	15,412	20,190	22,921
Benchmark (500Mio - 999Mio)	-	1,418	2,250	2,829	2,809	13,211	6,001	6,603	9,659	9,432
Others (below 500Mio)	-	-	1,425	965	1,698	1,064	462	2,706	5,734	3,222
Private Placement	-	-	-	-	-	10	-	1,180	1,400	1,534
Sum	5,000	10,668	12,675	25,813	31,673	120,906	33,870	25,900	36,983	37,109
Denominated in EURO	5,000	9,250	10,426	20,500	24,900	10,263	5,535	22,095	27,211	20,024
Denominated in domestic currency	-	1,418	2,189	2,829	1,023	110,643	28,335	2,788	8,290	15,041
Denominated in other currencies	-	-	60	2,483	5,750	-	-	1,018	1,482	2,044
Sum	5,000	10,668	12,675	25,813	31,673	120,906	33,870	25,900	36,983	37,109
Issuance fixed coupon	5,000	10,668	9,730	24,472	26,800	2,618	3,750	20,542	35,102	17,991
Issuance floating coupon	-	-	2,945	1,340	4,873	118,128	30,120	5,359	1,881	19,118
Issuance other	-	-	-	-	-	160	-	-	-	-
Sum	5,000	10,668	12,675	25,813	31,673	120,906	33,870	25,900	36,983	37,109
Number of New Issuers	1	2	2	2	1	11	3	1	-	-

Note: There are 12 regulated issuers each with one regulated mortgage programme (some regulated issuers also have unregulated programmes). For more details, please refer to the FCA's website (http://www.fca.org.uk/firms/systems-reporting/register/use/other-registers/rcb-register).

5.2.32 UNITED STATES

Outstanding (in EUR million)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Total Covered Bonds Outstanding										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	4,000	12,859	12,937	12,888	11,497	9,546	6,000
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Outstanding	-	-	-	4,000	12,859	12,937	12,888	11,497	9,546	6,000
Public Placement										
Benchmark (1bn and above)	-	-	-	4,000	12,859	12,937	12,888	11,497	9,546	6,000
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	4,000	12,859	12,937	12,888	11,497	9,546	6,000
Denominated in EURO	-	-	-	4,000	11,500	11,500	11,500	10,000	8,000	6,000
Denominated in domestic currency	-	-	-	-	1,359	1,437	1,388	1,497	1,546	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	4,000	12,859	12,937	12,888	11,497	9,546	6,000
Outstanding fixed coupon	-	-	-	4,000	12,859	12,937	12,888	11,497	9,546	6,000
Outstanding floating coupon	-	-	-	-	-	-	-	-	-	-
Outstanding other	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	4,000	12,859	12,937	12,888	11,497	9,546	6,000
Number of Issuers	-	-	-	1	2	2	2	2	2	2
Issuance (in EUR million)										
Total Covered Bonds Issuance										
Public Sector	-	-	-	-	-	-	-	-	-	-
Mortgage	-	-	-	4,000	8,859	-	-	-	-	-
Ships	-	-	-	-	-	-	-	-	-	-
Others	-	-	-	-	-	-	-	-	-	-
Total Issuance	-	-	-	4,000	8,859	-	-	-	-	-
Public Placement										
Benchmark (1bn and above)	-	-	-	4,000	8,859	-	-	-	-	-
Benchmark (500Mio - 999Mio)	-	-	-	-	-	-	-	-	-	-
Others (below 500Mio)	-	-	-	-	-	-	-	-	-	-
Private Placement	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	4,000	8,859	-	-	-	-	-
Denominated in EURO	-	-	-	4,000	7,500	-	-	-	-	-
Denominated in domestic currency	-	-	-	-	1,359	-	-	-	-	-
Denominated in other currencies	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	4,000	8,859	-	-	-	-	-
Issuance fixed coupon	-	-	-	4,000	8,859	-	-	-	-	-
Issuance floating coupon	-	-	-	-	-	-	-	-	-	-
Issuance other	-	-	-	-	-	-	-	-	-	-
Sum	-	-	-	4,000	8,859	-	-	-	-	-
Number of New Issuers	-	-	-	1	1	-	-	-	-	-

5.2.33 ANNEX: EUROPEAN CENTRAL BANK EXCHANGE RATES WITH THE EURO (YEAR END)

	Australian dollar	Brazilian real	Canadian dollar	Swiss franc	Czech koruna	Danish krone	UK pound sterling
2003	1.6802	3.6698	1.6234	1.5579	32.41	7.445	0.7048
2004	1.7459	3.6201	1.6416	1.5429	30.464	7.4388	0.70505
2005	1.6109	2.7462	1.3725	1.5551	29	7.4605	0.6853
2006	1.6691	2.8141	1.5281	1.6069	27.485	7.456	0.6715
2007	1.6757	2.5914	1.4449	1.6547	26.628	7.4583	0.73335
2008	2.0274	3.2436	1.6998	1.485	26.875	7.4506	0.9525
2009	1.6008	2.5113	1.5128	1.4836	26.473	7.4418	0.8881
2010	1.3136	2.2177	1.3322	1.2504	25.061	7.4535	0.86075
2011	1.2723	2.4159	1.3215	1.2156	25.787	7.4342	0.8353
2012	**1.2712**	**2.7036**	**1.3137**	**1.2072**	**25.151**	**7.461**	**0.8161**

	Hong Kong dollar	Hungarian forint	Iceland krona	Japanese yen	Korean won (Republic)	Lithuanian litas	Latvian lats
2003	9.8049	262.5	89.46	135.05	1506.32	3.4524	0.6725
2004	10.5881	245.97	83.6	139.65	1410.05	3.4528	0.6979
2005	9.1474	252.87	74.57	138.9	1184.42	3.4528	0.6962
2006	10.2409	251.77	93.13	156.93	1224.81	3.4528	0.6972
2007	11.48	253.73	91.9	164.93	1377.96	3.4528	0.6964
2008	10.7858	266.7	250*	126.14	1839.13	3.4528	0.7083
2009	11.1709	270.42	179.48*	133.16	1666.97	3.4528	0.7093
2010	10.3856	277.95	153.78*	108.65	1499.06	3.4528	0.7094
2011	10.051	314.58	159*	100.2	1498.69	3.4528	0.6995
2012	**10.226**	**292.3**	**168.91***	**113.61**	**1406.23**	**3.4528**	**0.6977**

* Bloomberg "Compound New York" Rates (On December 10, 2008, the European Central Bank has stopped publishing foreign exchange reference rates of the Icelandic Króna).

	Norwegian krone	New Zealand dollar	Polish zloty	Swedish krona	Singapore dollar	Turkish lira	US dollar
2003	8.4141	1.9244	4.7019	9.08	2.145	1771638	1.263
2004	8.2365	1.8871	4.0845	9.0206	2.2262	1836200	1.3621
2005	7.985	1.727	3.86	9.3885	1.9628	1.5924	1.1797
2006	8.238	1.8725	3.831	9.0404	2.0202	1.864	1.317
2007	7.958	1.9024	3.5935	9.4415	2.1163	1.717	1.4721
2008	9.75	2.4191	4.1535	10.87	2.004	2.1488	1.3917
2009	8.3	1.9803	4.1045	10.252	2.0194	2.1547	1.4406
2010	7.8	1.72	3.975	8.9655	1.7136	2.0694	1.3362
2011	7.754	1.6737	4.458	8.912	1.6819	2.4432	1.2939
2012	**7.3483**	**1.6045**	**4.074**	**8.582**	**1.6111**	**2.3551**	**1.3194**

Source: ECB, Statistics Data Warehouse.
Note: The Euro is the denominator.
Note: The exchange rate protocol used for ECBC covered bond statistics is to take the ECB bilateral exchange rate on the last business day of the year.

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