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**Panel on**

**“New legislation on covered bonds in Europe”**

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- Is there a mandatory OC?
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- Are liquid (substitute) cover assets allowed for the cover of mortgage covered bonds?
- Can the (special) administrator of the cover pool take a loan to get liquid assets? Would this loan rank pari passu with the covered bonds?
- Are there any specific regulations for the sale and transfer of mortgages respectively to other issuers? How easy is the sale of mortgage cover assets?

On 19<sup>th</sup> of July 2005, a new covered bonds legislation came into force, the “Pfandbriefgesetz” (PfandBG), which replaced the Mortgage Bank Act (Hypothekbankgesetz). The following information is based on the new PfandBG.

## I. Structure of the issuer

### 1. *Who is the issuer?*

The issuer is a fully equipped **credit institution**, which has a **special licence**.

### 2. *Does the issuer hold the cover assets on his balance sheet or are they transferred to a SPV guaranteeing the covered bonds?*

The cover assets are on the **balance sheet** of the **issuer**.

### 3. *Specialized bank principle?*

Pfandbrief issuers do **not** need to be specialised according to the PfandBG.

### 4. *What is the legal relation of the covered bonds and the cover assets - is there a direct legal link between each other?*

There is **no** direct link. ALM provisions regulate this relation.

In case of insolvency of the issuer, cover assets and Pfandbriefe enjoy a **special treatment**.

### 5. *Static or dynamic cover pool?*

- dynamic

## II. Only basic regulations on balance principle or sophisticated ALM-necessities?

§ 4 PfandBG contains several **basic regulations** on ALM: cover-principle, net present value and over-collateralisation (OC).

Regarding volume, interest rates and maturities, there is no identity between single assets and single Pfandbriefe. The issues of Pfandbriefe are much bigger than those of the single assets. The maturities of the assets usually are longer than those of the Pfandbriefe. The matching is concentrated on the relation between the maturity of the Pfandbrief and the period of fixed interest rates for the loans.

All Pfandbriefe must be **fully secured** by cover assets: loans to the public sector as well as land or ship mortgages, § 4 I PfandBG.

In addition to this **nominal cover calculation**, the issuer has to provide an **over-collateralisation (OC) of 2 %**, which must be invested in liquid assets.

A specific statutory order on **net present value** - the so called “Barwert” - prescribes in detail: how to calculate the net present value (procedure, stress scenarios, risk models etc.), how to keep the data and how to provide these data to the German banking supervisory authority (BaFin), § 4 VI PfandBG.

### III. What valuation and LTV criteria are regulated?

Regarding land mortgage collateral, only mortgages on **real estate located** in the following countries are **eligible** for the cover: EU- or EEA-countries, Switzerland, USA, Canada and Japan.

There is no absolute lending limit, only a **relative** one: This means that mortgage loans may have a higher LTV than 60 %, but only the part of the loan **up to 60 % LTV** is **eligible** for the cover pool.

The basis of this LTV calculation is the so called **mortgage lending value** (“Beleihungswert”) which has to be calculated in a different way compared to the market value. Details of the valuation procedure and the qualifications of the appraisers will be regulated in a specific **statutory order** on mortgage lending value, § 16 IV PfandBG.

### IV. Cover pool monitor and banking supervision

The German banking supervisory authority (BaFin) carries out the **supervision** on German Pfandbrief banks, § 3 PfandBG. It has the power to give any instructions which are appropriate and necessary to **ensure** that the Pfandbrief bank’s **business complies with the PfandBG** and all statutory orders based upon it.

The BaFin **grants** the Pfandbrief licence and can **revoke** it, if the legal conditions are no longer fulfilled by the Pfandbrief bank, § 2 PfandBG.

Very important is that the BaFin has to examine the cover pools on the basis of **suitable random checks**, which should be done at least **every two years**.

Furthermore, a **cover pool monitor** (“Treuhand”) 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. The BaFin will publish a specific **statutory order** on details of the form and the contents of this **cover register**, § 5 III PfandBG.

### V. How are segregation of cover assets and bankruptcy remoteness of covered bonds regulated?

#### 1. How to identify the cover?

- *Is there a cover register?*

Yes, § 5 PfandBG („Deckungsregister“).

- *What is registered?*

The **cover assets** being used to cover the Pfandbriefe as well as **claims under derivatives** shall be recorded in the cover register (§ 5 I 1 PfandBG).

By means of a **statutory order**, the **details** on form and necessary content of the **cover register** as well as details on the registrations will be stipulated (§ 5 III 1 PfandBG).

- *What is the legal effect of registration?*

Legal consequence of **registration** is the fact 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 are to be qualified as part of the separate legal estate.

Additional regulations deal with administration and the power of disposal on cover assets.

- *Who manages the cover register and who checks and supervises it?*

The **bank** carries out the **administration** of the cover register. It takes the appropriate measures to make sure that the prescribed cover is given at all times, § 4 IV PfandBG.

The **cover pool monitor supervises** the prescribed cover und registration in the cover register, § 8 I, II PfandBG. The **assets** recorded in the cover register – as well as the **deeds** relating to such assets - are safeguarded by the cover pool monitor **under dual control** (so called “Treuhändermitverschluss”) with the bank, § 9 PfandBG.

The **supervisory authority** also carries out the **supervision** of the cover register: It is supervising the **bank** (§ 3 PfandBG) as well as the **cover pool monitor**: It **appoints** the cover pool monitor and the appointment may be **revoked** by the supervisory authority at any time, provided that there is an objective reason, § 7 III PfandBG.

Furthermore, according to the future **statutory order** based on § 5 III PfandBG, copies of the cover register automatically shall be **transmitted** regularly to the supervisory authority. So this authority will be able to check – as stipulated in § 3 S. 3 and 4 PfandBG - whether the cover of the Pfandbriefe can be affirmed. The authority will carry out this supervision by suitable **random checks** every **two years**, which is a rule.

## 2. *How to segregate the cover assets from the insolvency’s estate?*

- *Is the segregation of the cover assets from the insolvency’s estate the consequence by operation of law of the start of the insolvency proceedings over the issuer’s assets, or are there any specific steps necessary?*

If the insolvency proceedings are **opened**, by operation of law, the assets recorded in the cover registers **do not** form **part** of the insolvency's estate (§ 30 I 1 PfandBG). Those assets will **not be affected** by the opening of the insolvency proceedings (§ 30 I 2 2. HS PfandBG).

They form a **separate legal** estate (or separate property: "Sondervermögen").

- *Who administrates the cover assets from then on? A special cover pool administrator or the normal insolvency administrator, who also is in charge of the issuer's assets?*

**After the opening** of the insolvency proceedings the **cover pool administrator** – the so called „Sachwalter” - carries out the administration of the cover assets (§ 30 II 1 PfandBG).

With the **appointment** of the cover pool administrator, the **right to manage and dispose** of the recorded assets will be **transferred** to him automatically by law (§ 30 II 2 PfandBG).

- *Do the cover assets form a separate legal estate, a pool administered in favour of the covered bond holders or are they held in (legal) trust?*

The cover assets form a **separate legal** estate.

### 3. *Are covered bonds touched by the insolvency procedure?*

- *Do covered bonds accelerate automatically, when the issuer goes insolvent?*

No, they do **not** accelerate automatically.

The Pfandbriefe will be satisfied according to the **conditions of the issue** and they will be **repaid** at the time of their **contractual maturity**.

- *What is the legal consequence of the insolvency of the issuer for the derivatives (and respective collateral), which are part of the cover?*

The derivatives, which are registered in the cover register, form a part of the separate legal estate. The insolvency procedure has the same consequences for them like for the Pfandbriefe and they profit of the same ranking like the Pfandbriefe.

There is no specific provision in the Pfandbrief Act, which regulates the legal situation of collateral, which is provided by the derivate partner or the Pfandbrief bank.

- *Do covered bond holders get a preferential treatment in the insolvency of the issuer? Are they restricted to this preferential treatment?*

Covered bond holders enjoy a **preferential treatment** in so far as the law stipulates the **separation** of the cover assets on the one hand and the insolvency's estate on the other hand, § 30 I PfandBG.

First of all, covered bonds shall be **fully satisfied** out of the assets recorded in the cover register. Only assets **remaining** after the Pfandbrief creditors are satisfied and the management costs are paid, those assets must be **surrendered** to the insolvency's estate (§ 30 IV 2 PfandBG).

The satisfaction of the Pfandbrief creditors is **not limited** to the cover assets. On the contrary, those creditors **also participate** in the insolvency proceedings in respect of the remaining Pfandbrief bank's assets – there, of course, only up to the **amount resulting from the default** (§ 30 I 3 i.V.m. VI 4 PfandBG).

- *Could a judicial stay (moratorium) on the insolvency's estate delay the cash flows from the cover assets and, therefore, endanger the timely payment of interest and the principle on covered bonds?*

**No**, as long as the separate legal estate has **sufficient liquidity**. Measures related to the insolvency's estate **do not affect** the **special** legal estate. This is especially because of the fact that the cover pool administrator **has direct access** to the cashflows.

However, a “moratorium” in the case of over-indebtedness or insolvency of the cover assets is generally **possible** – that is according to § 47 of the German Banking Act (Kreditwesengesetz: KWG); see esp. § 47 I Nr. 2, 1. HS KWG.

Moreover, the supervisory authority may take its own measures with respect to individual **cover pools** according to §§ 46, 46a KWG (§ 30 VI 1 PfandBG).

There is **no judicial suspension**. According to the above mentioned provisions the **competent authorities** solely are the **federal government** and the **supervisory authority**.

#### 4. *How to ensure liquidity in case of insolvency of the issuer?*

- *Who is entitled to the cover assets?*

The cover **pool administrator** is entitled.

With the **appointment** of the cover pool administrator, the right to **manage and dispose** of the recorded assets will be **transferred** to him by operation of law (§ 30 II 2 PfandBG).

According to § 30 III 1 PfandBG the right of management and disposition of the cover pool administrator **also extends** to those **mortgages** and **secured claims recorded** in the cover register, which are **not regarded as cover** for mortgage Pfandbriefe.

The cover pool administrator – having substracted the suitable administrative costs - will pay out that part of the cash flows to the insolvency administrator, which would account for the insolvency's estate in the case of separate loan contracts and the respective singular mortgages, § 30 III 3 PfandBG.

- ***Who has the first access to the cash flows on cover assets?***

The **cover pool administrator** has first access.

He will collect the cash flows according to their **contractual maturity** (§ 30 III 2 PfandBG). Also recorded partial claims not being used for the cover will be collected by him (§ 30 III 2 i.V.m. III 1 PfandBG).

- ***Is there a mandatory OC?***

Yes, there is a **mandatory over-collateralisation** (OC).

According to § 4 II PfandBG the cover must be ensured at all times according to the net present value ("Barwert") and the **net present value** of the recorded cover assets **must exceed by 2 percent** the total volume of the liabilities to be covered (so called "sichernde Überdeckung": over-collateralisation).

- ***Are there specific regulations that voluntary OC is insolvency remote?***

The law does **not** contain a provision **explicitly** affirming that question.

However, the **insolvency administrator** may only demand the over- collateralisation – as well as the cover assets in general – to be surrendered to the insolvency's estate **if those amounts** "... will obviously not be necessary as cover for the respective Pfandbrief category..." (§ 30 IV 1 PfandBG).

Therefore, the insolvency administrator will generally be able to claim recovery of the assets in favour of the insolvency's estate. However, the **burden of demonstration** as well as the **burden of proof** lies on him.

- ***Are liquid (substitute) cover assets allowed for the cover of mortgage covered bonds?***

Yes, they are allowed for the cover.

The cover stipulated under § 4 PfandBG may also be ensured by the **cover assets listed in § 19 PfandBG**.

- ***Can the (special) administrator of the cover pool take a loan to get liquid assets? Would this loan rank pari passu with the covered bonds?***

Yes, the cover pool administrator is **entitled to do so**.

That principle can be derived from § 30 II S. 5 PfandBG: 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 pools in the interest of the full satisfaction of the Pfandbrief creditors.

As this provision is of a rather **general term character**, also a loan would be within the scope of application.

Within the separate legal estate all liabilities are of **equal rank**.

- *Are there any specific regulations for the sale and transfer of mortgages respectively to other issuers? How easy is the sale of mortgage cover assets?*

**Yes**, there are specific regulations as to the **sale** and the **transfer of mortgages** respectively to **other issuers**.

- a) 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 an entirety **to another Pfandbrief bank**. This transfer requires the **written approval** of the supervisory authority.
- b) According to § 35 I PfandBG the **cover pool administrator** may **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**: In that case, the other Pfandbrief bank assumes the liability for the covered liabilities of the insolvent Pfandbrief bank.

By these two modalities, particular provisions had been created, according to which assets can be **more easily "transferred"** – which is in fact carried out **outside** the normally applicable provisions of civil law, e.g. the management in a fiduciary capacity of registered land charges (so called "Buchgrundschulden").

Both forms require a **written approval** of the supervisory authority.

In case of a **partial** transfer or a **partial** management in a fiduciary capacity, § 36 PfandBG will **additionally** – that means together with § 32 I or § 35 I PfandBG - be at issue: The **proportion** of the relevant cover pool which remains at the Pfandbrief bank must comply with the provisions concerning the cover for Pfandbriefe.

## **I. Structure of the issuer**

### **1. Who is the issuer?**

Issuer under the Mortgage Bank Act (Hypothekenbankgesetz) are Bank Austria and Erste Bank (private banks). The Mortgage Bond Act (Pfandbriefgesetz) applies to the Landes-Hypothekenbanken. The law on covered bonds applies to all other issuers.

### **2. Does the issuer hold the cover assets on his balance sheet or are they transferred to a SPV guaranteeing the covered bonds?**

Under Austrian law the cover assets are held on the balance sheet of the issuer. In the case of Pfandbriefstelle the cover assets may remain on the balance sheet of the member banks.

### **3. Specialized bank principle?**

For a new Hypothekenbank under the Mortgage Bank Act the special bank principle applies. There are exceptions for existing mortgage banks.

### **4. What is the legal relation of the covered bonds and the cover assets – is there a direct legal link?**

There are no direct claims of the bond holders against the cover assets. In case of insolvency of the issuer the cover assets are administered by a special administrator.

### **5. Static or dynamic cover pool?**

The cover pool is dynamic, i.e. the total volume of Pfandbriefe in circulation must at all times be covered by a sufficient amount of cover assets.

## **II. Only basic regulations on balance principle or sophisticated ALM-necessities?**

The following basic regulations apply:

Under Austrian law the total volume of bonds in circulation must at all times be covered at their nominal value by mortgages (or, in the case of public bonds by loans to public sector entities) of at least the same amount and with at least the same interest yield. In addition, an overcollateralisation of 2 % of the nominal value must be held.

The Articles of Association of the credit institution may provide, that in addition to cover at the nominal value cover at the net present value ("*Barwert*") must exist at all times.

In addition covered bonds may be issued only, if their maturities do not considerably exceed the period of time required in view of the maturities of the loans granted by the credit institution.

### III. What valuation and LTV-criteria are regulated?

Under the Mortgage Bank Act a 60% LTV applies. The same LTV of 60 % is regulated in the articles of association of the Landes-Hypothekenbanken, for which the Mortgage Bond act is applicable.

Only mortgages in EU or EEA-countries and Switzerland are eligible for cover.

### IV. Cover pool monitor and banking supervision

The trustee (Treuhand) has to control the cover register. The trustee is instituted by the Ministry of Finance.

The FMA (Financial Market Authority) is responsible for the banking supervision in Austria.

### V. Bankruptcy remoteness and segregation of cover assets

#### 1. How to identify the cover?

- ***Is there a cover register?***

There is a separate cover register for mortgage bonds (Hypothekenpfandbriefe) and public sector bonds.

- ***What is registered?***

All mortgages, substitute cover assets and hedging transactions that are assigned as cover are registered in the cover register.

- ***What is the legal effect of registration?***

If bankruptcy proceedings are instituted against the credit institution, the assets recorded in the cover register shall form a "Sondermasse" (i.e., a special estate for claims of secured creditors) for the claims of the mortgage bond creditors.

- ***Who manages the cover register and who checks and supervises it?***

The cover register is managed by the credit institution and supervised by the trustee.

#### 2. Segregation of the cover assets from the insolvency estate

- ***Is the segregation of the cover assets from the insolvency estate the consequence by operation of law of the start of the insolvency procedures over the issuer's assets, or are there any specific steps necessary?***

The segregation of the cover assets from the insolvency estate is a legal consequence of the insolvency proceedings.

- ***Who administers the cover assets from then on? A special cover administrator or the normal insolvency administrator, who also is in charge of the issuer's assets?***

The cover assets are administered by a special administrator appointed by the bankruptcy court in cooperation with the Financial Market Authority (FMA).

- ***Do the cover assets form a separate legal estate, a pool administered in favour of the covered bond holders or are they held in trust?***

The cover assets are administered by the special administrator in favour of the bond holders and due claims of the bond holders are satisfied from the "Sondermasse" (special estate). The special administrator's task is to sell the cover assets collectively to a suitable credit institution, which shall take over all liabilities arising under the covered bonds.

### **3. Are covered bonds touched by the insolvency procedure?**

- ***Do covered bonds accelerate automatically, when the issuer goes insolvent?***

Under the new provisions, effective since June 1st, 2005 there is no longer an acceleration of payments in case of insolvency of the issuing bank.

- ***What is the legal consequence of the insolvency of the issuer for the derivatives (and respective collateral), which are part of the cover?***

The claims of the counterparty under the derivatives transaction rank pari passu with with the claims of the mortgage bond creditors.

- ***Do covered bond holders get a preferential treatment in the insolvency of the issuer? Are they restricted to this preferential treatment?***

The mortgage bond creditors may only assert their claims as creditors of the insolvent credit institution in the amount of the loss or, as long as such loss has not been finally established, the presumable loss.

- ***Could a judicial stay (moratorium) on the insolvency estate delay the cash flows from the cover assets and therefore endanger the timely payment of interest and the principle on covered bonds?***

A moratorium scenario is unlikely, as the special administrator has to use the cash flows from the cover assets for the claims of the bond holders (principal and interest). Only if the assets in the cover register are insufficient for satisfying the claims of the bond holders, the claims of the bond holders are accelerated.

### **4. How to ensure liquidity in case of insolvency of the issuer?**

- ***Who is entitled to the cover assets?***

The special administrator has to take any administrative measures which are necessary to satisfy the claims of the bond holders.

- ***Who has the first access to the cash flows on cover assets?***

The special administrator has to administrate the “Sondermasse” (special estate) and to use the cash flows of the cover assets for the claims of the bond holders according the maturity of the bonds.

- ***Is there a mandatory OC?***

An overcollateralization of 2% of the nominal value of the bonds, must be held at all times in highly liquid substitute cover.

- ***Are there specific regulations that voluntary OC is insolvency remote?***

Any voluntary OC is also insolvency remote, as only those assets of the “Sondermasse” (special estate), that are obviously not needed to cover the claims of the mortgage bond creditors (and other costs) are passed on to the insolvent credit institution.

- ***Are there liquid (substitute) cover assets allowed in the cover of mortgage covered bonds?***

A maximum of 15 % of the outstanding covered bonds may be held in highly liquid assets, such as debentures issued by public-law corporations, deposits in bank accounts with a Zone A central bank or credit institution.

- ***Can the special administrator of the cover pool take out a loan to get liquid assets? Would this loan rank pari passu with the covered bonds?***

The special administrator shall satisfy from the special estate any claims of the mortgage bond creditors which are already due and shall take any administrative measures which are necessary to that end with effect for the special estate, for instance by collecting mortgage claims which are already due, by selling individual cover assets or by interim financing. Such loans would rank pari passu with the claims of the bond holders and the claims under derivatives transactions in the cover register.

- ***Are there any specific regulations for the sale and transfer or mortgages respectively to other issuers? How easy is the sale of mortgage cover assets?***

The special administrator has to sell the assets entered into the cover register collectively to a suitable credit institution. This credit institution has to take over any liabilities arising under the mortgage bonds.

## **I. Structure of the issuer:**

### **1. Who is the issuer?**

The issuer is the bank that transfers the assets to the SPV, but could also be a different one belonging to the same banking group or consortium.

### **2. Does the issuer hold the cover assets on his balance sheet or are they transferred to a SPV guaranteeing the covered bonds?**

The cover pool is transferred to an SPV.

### **3. Specialized bank principle?**

The Italian system does not contemplate such a principle although Bank of Italy might distinguish, in terms of certain issuing limits for covered bonds ("CB"), between banks which are specialised in granting mortgages or public lending and do not hold retail deposits or current accounts.

### **4. What is the legal relation of the covered bonds and the cover assets - is there a direct legal link?**

In the Italian CB legislation the direct link is established by way of an independent first-demand guarantee extended by the SPV in the sole favour of the CB holders which is triggered in case of non payment or default of the issuer (the bank).

### **5. Static or dynamic cover pool?**

The cover pool must be integrated by the bank issuing the CB/transferring the assets from time to time in order to maintain certain ratio limits between [NPV of] cover pool assets and CB outstanding [and can not be substituted but only integrated].

## **II. Only basic regulations on balance principle or sophisticated ALM-necessities?**

The Italian CB legislation aims to provide, with regard to the balance between cover pool and CB, both basic principles of a minimum level of overcollateralisation and some more sophisticated ALM provisions to ensure that i) the NPV of the cover pool is always equal or greater of the CB outstanding, taking into consideration also the maintenance cost of the SPV and derivatives and ii) the positive cash flows generated by the cover pool are sufficient to meet interests payments on the outstanding CB.

## **III. What valuation and LTV criteria are regulated?**

The Italian CB legislation will cover maximum LTVs ratios for both commercial and residential mortgages. In particular residential can have an LTV as high as 80% of the property value while commercial ones can reach 60% in order to be eligible for the cover pool. These LTV limits might be exceeded in case of a suitable mortgage guarantee, even if it is not yet clear whether the CRD will allow this. With regards to property valuation some general criteria could be regulated by Bank of Italy although it is not yet clear how specific that will be. Ideally a common valuation methodology should be introduced or a national property value index to be used for automatic and continuing re-valuation of properties.

#### IV. Cover monitor and banking supervision

The so called asset monitor role is initially established by the primary law while the more detailed rules, methodology and criteria for valuating, from time to time, are yet to be established by Bank of Italy. The idea, however, is that the role should be taken by a well established and recognised auditing firm or any another consulting/auditing type of firm with high standards of respectability, credibility and reputation together with a proven capacity for reporting and data management skills.

The banking supervision is entirely a prerogative of Bank of Italy which, on top of its general mandate of supervising the entire banking system stability and competition will specifically set the requisite of the banks allowed to issue CB. It will also set the limits in terms of volume of CB that can be issued by a specific bank in relation to its assets

#### V. How are segregation of cover assets and bankruptcy remoteness of covered bonds regulated?

The segregation of the cover pool is regulated by a *pro-soluto* (true-sale) transfer of the assets to an SPV regulated by the Italian securitisation law (law n.130/99) and the bankruptcy remoteness is regulated through a limited recourse claim of CB holders on the cover pool belonging to the SPV. In other words the guarantee extended by such SPV to the CB holders is limited recourse on the cover pool assets, this way, by operation of law, the SPV survival is achieved- similarly to securitisation transactions.

This item V. on insolvency law is decisive for all rating agencies. During the last years, we had to amend our German legislation several times to make them comfortable with our legislation. Therefore, we could go more in details with this item. Here, I propose to deal with the following questions:

##### 1. *How to identify the cover?*

The cover pool is segregated to an SPV by a true-sale of the assets.

- ***Is there a cover register?***

No, in the Italian scheme it is not necessary. The transfer however will be made according to eligibility criteria which are objective and which make the transferred assets clearly identifiable.

- ***What is registered?***

See above

- ***What is the legal effect of registration?***

See above

- ***Who manages the cover register and who checks and supervises it?***

The figure of the Asset Monitor has been introduced by the primary legislation, Bank of Italy will deal with the obligations of the bank to maintain the quality of the cover pool unchanged through the life of the CB and these obligations will be implemented by the

issuing bank and the Asset Monitor jointly. The Asset Monitor will be empowered to be able to force such actions by the bank.

**2. *How to segregate the cover assets from the insolvency estate? See above, the cover assets are held by an SPV therefore on a segregated basis from the insolvency estate.***

- ***Is the segregation of the cover assets from the insolvency estate the consequence by operation of law of the start of the insolvency procedures over the issuer's assets, or are there any specific steps necessary?***

See above

- ***Who administrates the cover assets from then on? A special cover administrator or the normal insolvency administrator, who also is in charge of the issuer's assets?***

The idea, under the Italian scheme, is that the issuing/transferring bank will continue to service the cover pool until an insolvency situation or payment suspension. Thereafter a substitute servicer will be appointed by the Asset Monitor to continue the activity. It is possible that, through contractual provisions, a set of eligible servicer to be approved by, amongst others, rating agencies will be decided at inception. The idea is that the SPV and the Asset Monitor are able to appoint the subject quickly upon certain trigger events signalling the worsening financial conditions of the issuer of CB.

- ***Do the cover assets form a separate legal estate, a pool administered in favour of the covered bond holders or are they held in (legal) trust?***

Under the Italian legislation the cover pool forms a separate legal estate due to the fact that is transferred (true-sale) to an SPV.

**3. *Are covered bonds touched by the insolvency procedure?***

Due to the above feature the insolvency procedure of the bank does not touch the cover pool. It is still to be defined the possibility of the SPV to participate to the insolvency procedure of the bank should the cover pool not suffice to repay the outstanding CB.

- ***Do covered bonds accelerate automatically, when the issuer goes insolvent?***

The secondary legislation will rule that no automatic acceleration of CB will take place in case of insolvency, suspension of payments or financial distress of the issuing bank. This feature seems to be a key issue for rating agencies in order to apply the de-linkage approach with reference to the rating of the issuing bank and the rating of the CB issued by such bank.

- ***What is the legal consequence of the insolvency of the issuer for the derivatives (and respective collateral), which are part of the cover?***

At the moment there is no specific provision for this in the law. It is expected however that derivatives, which are part of the cover pool, will have to have collateral posting mechanisms to protect such event. It is foreseeable that only standard contractual provision under the derivatives documentation will regulate such event.

- ***Do covered bond holders get a preferential treatment in the insolvency of the issuer? Are they restricted to this preferential treatment?***

Under the current scheme of legislation the CB holders do not get a preferential treatment in case of insolvency, although this is not a final decision. The idea however is to act on the constant quality of the cover pool to ensure that it is always sufficient to repay the outstanding CB.

- ***Could a judicial stay (moratorium) on the insolvency estate delay the cash flows from the cover assets and therefore endanger the timely payment of interest and the principle on covered bonds?***

Under the Italian scheme this should never be the case since the new servicer will be able to freely manage, jointly with the Asset Monitor, the cover pool held at the SPV level.

#### ***4. How to ensure liquidity in case of insolvency of the issuer?***

There are various possibilities: the first is to maintain a stringent cover ratio between the CB coupon payments and the cash flows generated by the cover pool during the life of the transaction (minimum excess spread of the portfolio of assets). The Italian law also allow the usage of liquidity facility should this deemed to be necessary.

- ***Who is entitled to the cover assets?***

Under the Italian legislation there is a preferential ranking established by operation of law. The CB holders, the derivatives counterparties and the liquidity line providers (if any) are entitled to it.

- ***Who has the first access to the cash flows on cover assets?***

The CB holders.

- ***Is there a mandatory OC?***

Under Italian law, there is a mandatory minimum overcollateralisation. In particular the ratio between CB and cover pool assets cannot be above 1. There are also specific limits in order to ensure that the NPV of the cover pool adequately covers the outstanding CB taking also into account the SPV costs.

- ***Are there specific regulations that voluntary OC is insolvency remote?***

No.

- ***Are there liquid (substitute) cover assets allowed in the cover of mortgage covered bonds?***

Under the Italian scheme it is envisaged to allow liquid, short term highly rated assets ranging from bank deposit (within a financial institution rated at least AA-) to bank notes with a maximum maturity of 1 year.

- ***Can the (special) administrator of the cover pool take out a loan to get liquid assets?***

Under the Italian CB law the SPV does take a subordinated loan from the issuing bank in order to fund the acquisition of the cover pool assets. It is envisaged the possibility for the SPV to obtain a liquidity facility.

- ***Would this loan rank *pari passu* with the covered bonds?***

See above for the loan to buy additional assets for the cover pool. With regards to liquidity facility it will be regulated contractually but it could logically be expected to be *pari passu*.

- ***Are there any specific regulations for the sale and transfer of mortgages respectively to other issuers?***

There are no specific regulations in this regard.

- ***How easy is the sale of mortgage cover assets?***

It is expected that in case of an emergency scenario the cover pool could be sold to another SPV and securitised or to a different bank interested in issuing CB.

Legislation on covered bonds in Lithuania:

1. Law on Mortgage Bonds and Mortgage Credits effective since 25<sup>th</sup> of September 2003;
2. Resolution of the Bank of Lithuania on Approval of Investment Procedure of Temporally Free Funds and Accounting of Mortgage Credits and other Additional Assets.
3. Other legal acts that accordingly also regulate issues related to covered bonds (Law on Companies, Law on Banks, Law on Bankruptcy).

## ***1. Structure of the issuer***

### ***1. Who is the issuer?***

A commercial bank of Lithuania or a foreign bank branch operating in Lithuania, which have a license to carry on the activities of the credit institution and issue mortgage bonds, grant mortgage credits. However, issue of the mortgage bonds by commercial banks that are organized in the legal form of private limited liability company is prohibited.

### ***2. Does the issuer hold the cover assets on his balance sheet or are they transferred to a SPV guaranteeing the covered bonds?***

The cover assets are on the balance sheet of the issuer. However, under the regulations of the Bank of Lithuania, a banking supervisory authority, accounting for cover assets and mortgage bonds must be kept separately from other assets and liabilities of the issuer.

Moreover, under the Resolution of the Bank of Lithuania, the issuer shall approve a detailed procedure for accounting of cover assets.

### ***3. Specialized bank principle?***

Mortgage bond issuers do not need to be specialised according to the legal acts of Lithuania.

### ***4. What is the legal relation of the covered bonds and the cover assets - is there a direct legal link between each other?***

There is no direct link.

However, in case of insolvency the rights to claim against cover assets may be used only for meeting the creditor claims of the holders of mortgage bonds. Recovery from the cover assets shall not be enforced against the other obligations of the issuer unless the claims of the holders of mortgage bonds have been met.

### ***5. Static or dynamic cover pool?***

Dynamic.

## II. Only basic regulations on balance principle or sophisticated ALM-necessities?

According to Law on Mortgage and Mortgage Credits the following requirements are established:

- a. nominal value of the mortgage bonds may not be higher than the amount of mortgage credits and temporally free fund (TFF)\*;
- b. TFF may not exceed 10% of nominal value of mortgage bonds;
- c. the annual rate on mortgage bonds must be no higher than annual interest rate on mortgage credits;
- d. in case of mortgage bond issue with fixed interest rate, the mortgage credit must have fixed interest rate; meanwhile, in case of mortgage bond issue with variable interest rate, mortgage credits must have variable interest rate;
- e. the issue of mortgage bonds shall be made in that currency in which mortgage credits are granted;
- f. redemption terms for mortgage bonds must be no longer than repayment maturities of mortgage bonds.

\*TFF according to Law on Mortgage and Mortgage Credits are funds received upon repayment of mortgage credits or part thereof prior to their use for redemption of mortgage bonds, payment of interest, granting of mortgage credits.

In case nominal value of mortgage bonds becomes higher than the sum of mortgage credits and TFF, the issuer shall use TFF in the following order of priority:

- (i) redemption of mortgage bonds or part thereof from the holders of mortgage bonds and payment of interest under terms and in the order of priority provided under terms and conditions by the issue;
- (ii) granting mortgage credits that could be used to cover mortgage bonds;
- (iii) purchase of mortgage bonds on the secondary market;
- (iv) redemption of mortgage bonds or part thereof from the holders of mortgage bonds before their maturity in case mortgage credits or part thereof have been repaid before their maturity and the funds received have not been used in the manner set forth in subparagraphs i-iii.

Prior to the use of TFF as indicated above, TFF must be invested into liquid and risk-free assets determined by the Bank of Lithuania. Currently under the Resolution of the Bank of Lithuania as assets may constitute securities issued by the Government of the Republic of Lithuania and governments and central banks of group A countries, loans granted to banks of group A countries, etc.

### III. What valuation and LTV criteria are regulated?

Pursuant to Law on Mortgage and Mortgage Credits, the amount of the mortgage credit shall be no higher than:

- (i) 50% of the mortgage value of the collateralized land plot on which a housing is built;
- (ii) 40% of the mortgage value of other collateralized land plot;
- (iii) 70% of the mortgage value of collateralized housing;
- (iv) 50% of the mortgage value of collateralized item of immovable property, except for construction in progress that is not allowed to be pledged to secure claims arising from mortgage bonds.

Moreover, the mortgage value of items of immovable property, other than a housing and land plot on which that housing is built, mortgaged to secure claims of mortgage credits may not exceed 30% of nominal value of mortgage bonds.

The mortgage value of collateralized immovable property is assessed under common requirements that are applicable in calculating the market value.

### IV. Cover pool monitor and banking supervision

The issuer is obliged from the next quarter after mortgage bond issue to furnish the Bank of Lithuania, the banking supervisory authority, with report on mortgage credits and other assets that secure claims arising from mortgage bonds. A report must be made under requirements set forth by the Bank of Lithuania.

The procedure for investment of TFF must be included in the internal control system of the issuer and must be within the scope of the internal audit of the issuer.

### V. How are segregation of cover assets and bankruptcy remoteness of covered bonds regulated?

#### 1. How to identify the cover?

- *Is there a cover register?*

Yes.

- *What is registered?*

Mortgage credits and other assets that secure claims arising from mortgage bonds.

The register is made under requirements set forth by the Bank of Lithuania.

- ***What is the legal effect of registration?***

Legal consequence of registration is the fact that in the case of insolvency of the issuer, the assets covering mortgage bonds can be identified.

- ***Who manages the cover register and who checks and supervises it?***

The issuer carries out the administration of the cover register.

The Bank of Lithuania exercises the supervision of the cover register. Each quarter after the mortgage bond issue the report on the register must be submitted to the Bank of Lithuania.

Moreover, under the Resolution of the Bank of Lithuania the amount of temporally free funds shall be calculated each business day.

## ***2. How to segregate the cover assets from the insolvency's estate?***

- ***Is the segregation of the cover assets from the insolvency's estate the consequence by operation of law of the start of the insolvency proceedings over the issuer's assets, or are there any specific steps necessary?***

In case of insolvency the rights to claim against cover assets may be used only for meeting the creditor claims of the holders of mortgage bonds. Recovery from the rights to claim against cover assets shall not be enforced against the other obligations of the credit institution unless the claims of the holders of mortgage bonds have been met.

- ***Who administrates the cover assets from then on? A special cover pool administrator or the normal insolvency administrator, who also is in charge of the issuer's assets?***

After opening of the insolvency proceedings the normal administrator carries out the administration of the cover assets.

- ***Do the cover assets form a separate legal estate, a pool administered in favour of the covered bond holders or are they held in (legal) trust?***

The cover assets do not form a separate legal estate. The cover assets are not held in (legal) trust.

## ***3. Are covered bonds touched by the insolvency procedure?***

- ***Do covered bonds accelerate automatically, when the issuer goes insolvent?***

No, they do not accelerate automatically.

Mortgage bonds will be satisfied according to the conditions of the issue and they will be repaid at the time of their contractual maturity.

- ***What is the legal consequence of the insolvency of the issuer for the derivatives (and respective collateral), which are part of the cover?***

The collateral, which is registered in the cover register, may be used only for meeting the creditor claims of the holders of mortgage bonds. Recovery from the rights to claim against collateral pledged shall not be enforced against the other obligations of the credit institution unless the claims of the holders of mortgage bonds have been met

- ***Do covered bond holders get a preferential treatment in the insolvency of the issuer? Are they restricted to this preferential treatment?***

Covered bond holders enjoy a preferential treatment in so far as the law stipulates that they have a priority right to the recovery from the cover assets.

The satisfaction of the mortgage holders is not limited to the cover assets. They also participate in the insolvency proceedings in respect of the remaining issuer's assets up to the amount resulting from the default.

- ***Could a judicial stay (moratorium) on the insolvency's estate delay the cash flows from the cover assets and, therefore, endanger the timely payment of interest and the principle on covered bonds?***

Yes, it can endanger the timely payment of interest and the principle of mortgage bonds. According to Law on Banks, in case of moratorium the issuer is prohibited to fulfil the liabilities to pay or transfer the assets of issuer, as well as, pay interest accrued on the obligations of the issuer.

#### ***4. How to ensure liquidity in case of insolvency of the issuer?***

- ***Who is entitled to the cover assets?***

The administrator is entitled.

- ***Who has the first access to the cash flows on cover assets?***

The administrator has first access.

- ***Is there a mandatory OC?***

No, there is no a mandatory over-collateralisation (OC).

According to Law on Mortgage Bonds and Mortgage Credits, nominal value of mortgage bonds shall not be higher than the sum of mortgage credits and TFF.

- *Are there specific regulations that voluntary OC is insolvency remote?*

Pls. see the answer above.

- *Are liquid (substitute) cover assets allowed for the cover of mortgage covered bonds?*

Yes, they are allowed for the cover.

- *Can the (special) administrator of the cover pool take a loan to get liquid assets? Would this loan rank pari passu with the covered bonds?*

No.

- *Are there any specific regulations for the sale and transfer of mortgages respectively to other issuers? How easy is the sale of mortgage cover assets?*

No, there is no specific regulation on sale and transfer of mortgages.