The institutional framework for the functioning of covered bonds (list zastawny - L.Z.) in Poland was established already in 1997 and first issues took place in 2000; by 2013, L.Z. accounted for a few percent of property market funding, mostly with respect to commercial property. The latest liquidity limits introduced by the requirements of Basel III and of the Capital Requirements Directive / Regulation (CRD / CRR4) will persuade banks to show greater interest in long-term funding instruments to some extent, but in order to improve the L.Z. system in Poland more comprehensively, further changes to the legal environment are necessary so as to achieve significantly better ratings compared to unsecured bonds. The adjustment of the mortgage banking business model that assumes a synergy between the credit policy and the policy for funding mortgage portfolios with L.Z. within groups will also be of essential importance.

The direction of systemic solutions represented by the Polish L.Z. and the quality of the collateral provided by safe assets are commensurate with the expectations of investors who tend to be wary following the sub-prime crisis. The key issue will be to achieve a larger issuance scale as well as to ensure market liquidity. The authors of this analysis express their opinion on success factors in the Polish market environment.

1. Legal Framework for L.Z. Issuance in Poland.

Foundations for the development of the Polish L.Z. market were laid in 1997 when the Act on Covered Bonds and Mortgage Banks (ACBMB) was adopted. In this manner, after more than fifty years, legal grounds for issuing L.Z. and the operation of mortgage banks were restored in Poland.[1]

Pursuant to the Act, the only entities authorised to issue L.Z. are mortgage banks incorporated as joint stock companies. In order to minimise the risk associated with their operations, the list of activities which mortgage banks are authorised to engage in has been limited to only include low-risk activities. The basic activity of mortgage banks consists of granting loans secured by mortgages and issuing <u>L.Z.</u> on this basis as well as of granting loans to public entities set forth in the Act and issuing <u>public L.Z.</u> on this basis. Moreover, pursuant to Article 15 of the ACBMB, a mortgage bank may, within a specified scope, engage in the following additional activities: (i) accept time deposits; (ii) take out loans; (iii) issue bonds; (iv) safekeep securities; (v) purchase and take up shares in other entities whose legal form ensures that the liability of the mortgage bank is limited to the amount of assets invested; (vi) maintain bank accounts used for the servicing of investment projects carried out using loans granted by the mortgage bank; (vii) provide consulting and advisory services related to the property market, including with respect to the determination of the mortgage lending value of property.

The ACBMB imposes a number of rules that limit the risk associated with mortgage bank operations, possibly even at the expense of achieving higher profits. The Act also

[1] Before World War II, L.Z. were issued under the Regulation of the President of the Republic of Poland of 17 March 1928 on Banking Law (Journal of Laws [Dz. U.] No. 34/1928 item 321). The long-term loan (used by issuers of L.Z.) was abolished in 1948 (cf. Decree of 25 October 1948 on the principles and procedures of abolition of some types of long-term loans, Journal of Laws [Dz. U.] No. 52/1948 item 411 and Decree of 25 October 1948 on the banking reform, Journal of Laws [Dz. U.] of 1951 item 279).

contains a number of provisions that ensure the security of the L.Z. itself, which include in particular making the possibility of issuing such securities conditional on meeting statutory conditions and subjecting such activities to strict supervision. These provisions concern: ensuring solvency, which is essentially guaranteed by the principle limiting the total amount of L.Z. outstanding (Article 17 of the Act) and the principle of congruence between interest costs and income, and additionally the principle of ongoing cover for L.Z. (Article 18 of the Act) and the limit on refinancing with L.Z. (Article 14 of the Act).

Summing up, the rules governing the operation of mortgage banks in Poland make the cost of their activities relatively high, but at the same time such activities are highly secure. This, however, does nothing to change the fact that, despite good regulations and a high level of safety provided by L.Z., the market for L.Z. in Poland has not developed significantly during the last 13 years.

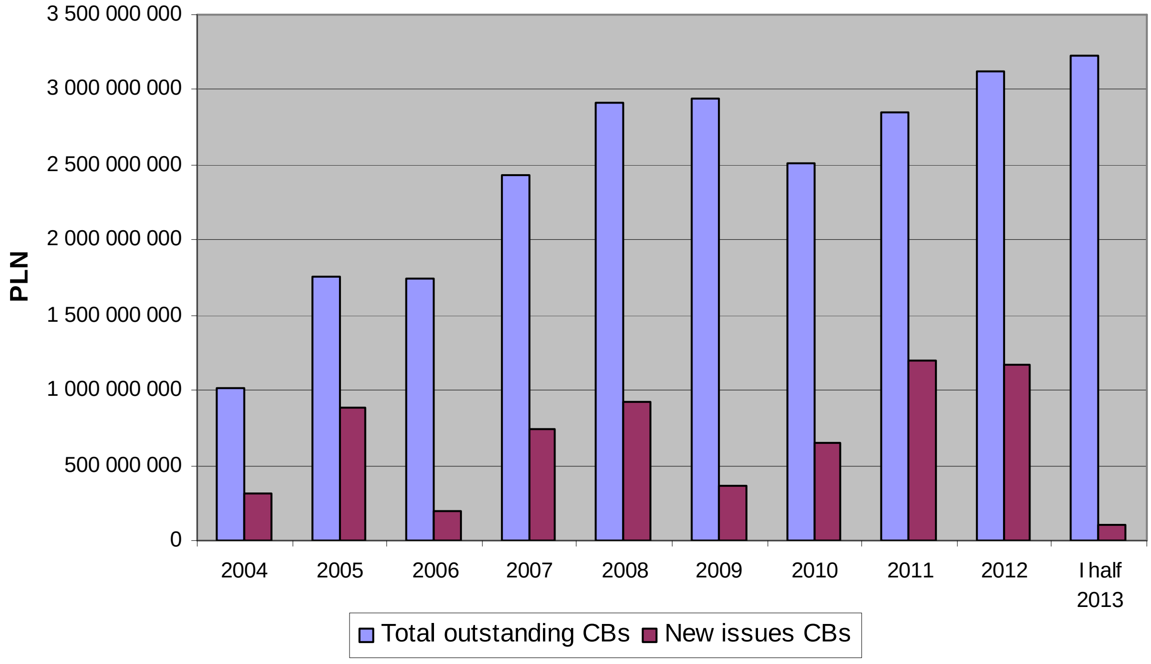
2. Development of the L.Z. Market in Poland

The first post-war issue of L.Z. took place in 2000, but in fact the market only began to operate in a meaningful way from 2005 onwards. Initially, only L.Z. were present on the market; from 2008 onwards, the issuance of public L.Z. commenced as well. L.Z. were issued by three specialised banks: BRE Bank Hipoteczny, Pekao Bank Hipoteczny and Śląski Bank Hipoteczny/ ING Bank Hipoteczny (the last one operated until October 2011).

Currently, two issuers are active on the Polish market: BRE BH accounts for about 70% of the market, while Pekao BH services the remaining 30%. As at end June 2013, total liabilities incurred by mortgage banks arising from the issuance of L.Z. exceeded PLN 3.22 billion, of which L.Z. accounted for ca. PLN 2,766 million and public L.Z. for ca. PLN 455 million.[2]

[2] Data on L.Z. issuance (in annual terms) are published on the website of the Polish Mortgage Credit Foundation (Fundacja na rzecz Kredytu Hipotecznego): http://fundacja1.home.pl/ehipoteka/pol/Statystyki/Listy-zastawne

Figure 1. Covered bonds in Poland



source: Polish Mortgage Credit Foundation

On the market, issues denominated in Polish zloty prevail, which amount to ca. PLN 100–250 million each[3] (the still poor development of the L.Z. system in Poland is reflected by the fact that no Jumbo issues[4] have been conducted so far, which is a major shortcoming of this market, especially for institutional investors). Maturities of Polish L.Z. range from 3 to 7 years; there was a noticeable reduction in those periods when the financial crisis struck with full force (2008–2009), but now – in better economic climate and given increased confidence in the interbank market – most L.Z. are issued for 6 or 7 years and investors hold them until maturity (there is virtually no secondary market in Polish L.Z.).

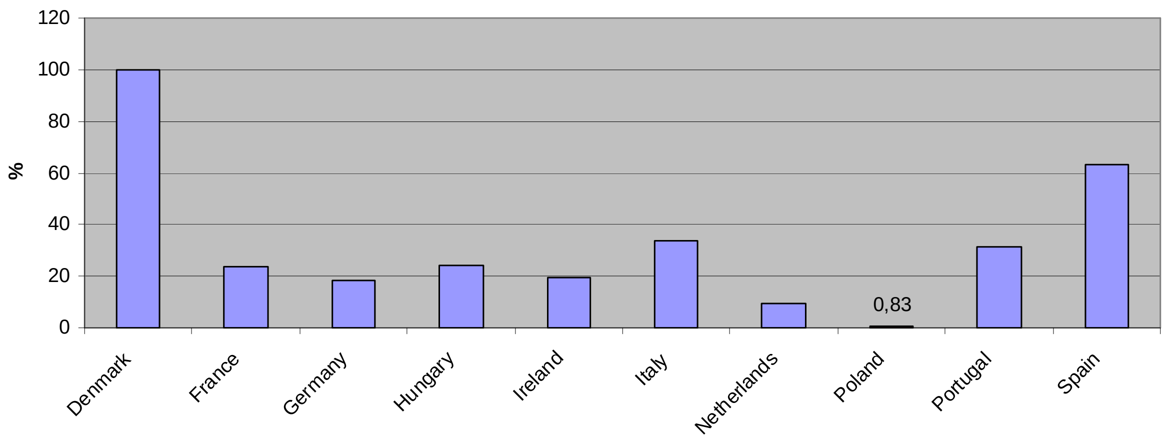
It should be stressed that, in contrast to European trends where about 70% of covered bonds issued are fixed-rate securities, Polish L.Z. are generally floating-rate ones (although in July 2013, BRE BH issued 7-year L.Z. denominated in EUR with a fixed interest rate). This composition of L.Z. corresponds to the characteristics of the Polish mortgage loan portfolio in which variable-rate loans clearly dominate. It should also be pointed out that while the reference rate for mortgage loans denominated in PLN is the WIBOR 1M or 3M, in the case of L.Z. the reference rate is WIBOR 6M, which adversely affects yields in the case of sudden changes in the interbank market (increases in spreads between rates).

[3] All data on L.Z. issuance characteristics are based on the figures provided by mortgage banks to the Polish Mortgage Credit Foundation.
[4] An issue of the order of EUR 500 to 1,000 million.

Share of L.Z. in portfolio funding

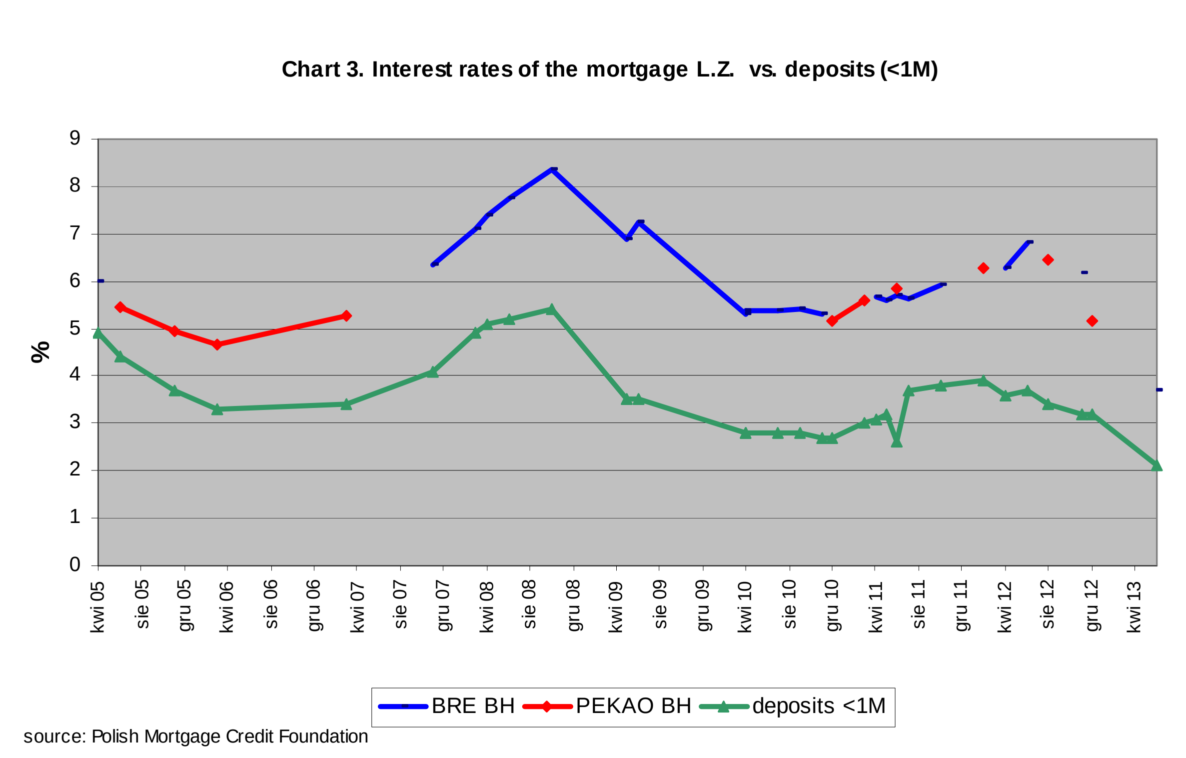
Despite the clear development of the market, which has taken place in recent years, the funding of mortgage portfolios with L.Z. is not yet sufficiently well developed in Poland. Less than 1% of the residential loan portfolio is currently refinanced through L.Z., while e.g. in Hungary this ratio has exceeded 20%, and in the Czech Republic it is higher than 40% (cf. Figure 2). **The average share of covered bonds in funding of European residential markets is about 25%**, which indicates the still-present potential for the development of this instrument in Poland.

Figure 2. Share of covered bonds in residential loans' funding (2012)



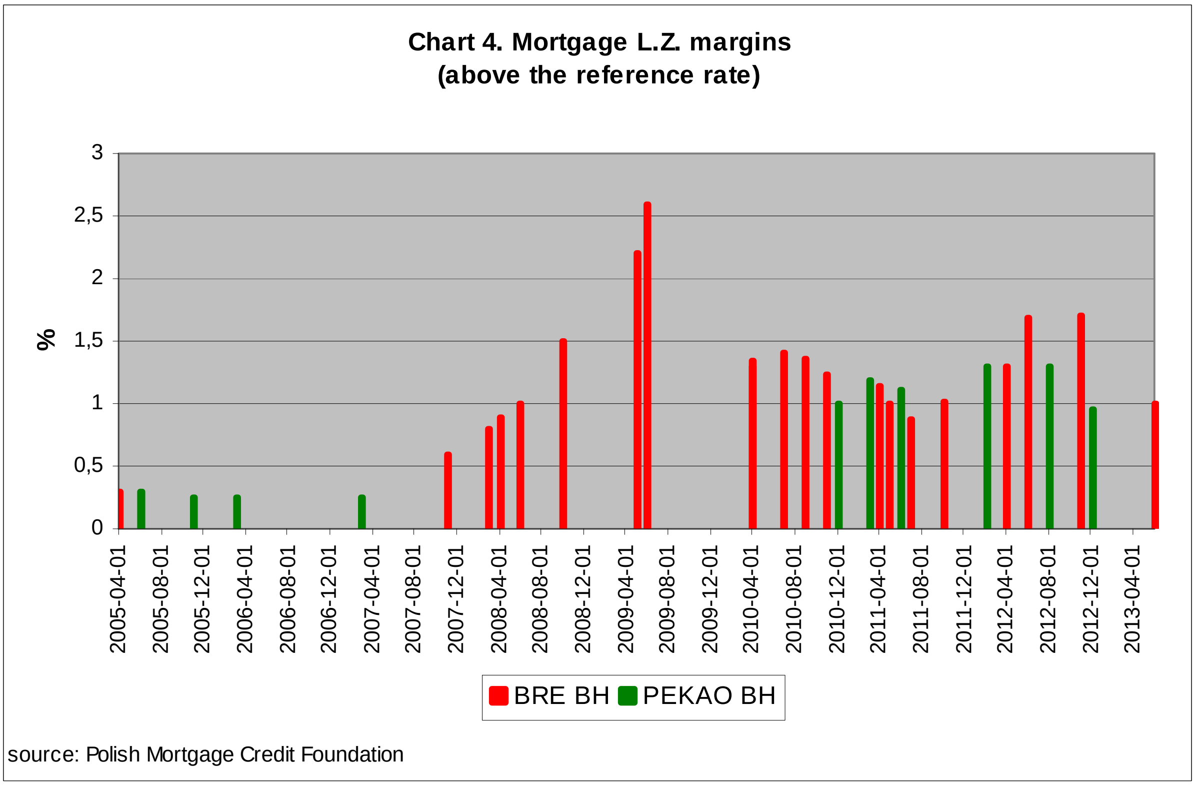
source: Polish Mortgage Credit Foundation

The low share of L.Z. in mortgage portfolio funding in Poland results from economic considerations as well as the absence of systemic incentives that could mitigate the high (compared to deposits) price of capital raised through the issuance of L.Z. One should also point to the strict credit standards applied by mortgage banks and the excess liquidity observed until recently in the sector, which discouraged the use of L.Z. Having easy access to cheap deposits and subordinated loans from their parent companies, banks had no incentive whatsoever to use long-term funding instruments (cf. Figure 3). At the same time, the conditions in which mortgage banks operated meant that their loan offerings could not really compete against those of universal banks, which was, among other things, due to the specialised banks' inability to take retail deposits, more stringent credit limit conditions, the requirement to use mortgage lending appraisals when estimating the value of collateral, etc. While subject to the above limitations on their own business, mortgage banks could not cooperate effectively with universal banks by issuing L.Z. on the basis of the loans granted by universal banks, since this was prevented by problems with the transfer of mortgage claims and the fact that this business model was absent from corporate strategies.



Another factor which impacted the competitiveness of the mortgage banks' offering was the fact that pursuant to Article 18, para. 2 of the ACBMB, the mortgage bank's income from interest on its mortgage-secured claims cannot be lower than the cost arising from the interest on outstanding L.Z., and these limits must be supervised by the trustee and reported to the Polish Financial Supervision Authority. Given the fact that in order to attract demand for Polish L.Z., issuers had to offer relatively high margins, the need to balance the mortgage bank's cost and income related to the issuance of L.Z. made the mortgage loans offered by such banks even more expensive. This has been yet another factor limiting their activities and contributing to the relatively small scale of L.Z. issuance.

It is worth emphasising that the aforementioned problem was exacerbated especially at the peak of the financial crisis and during the credit crunch when L.Z. margins over and above the reference rate jumped from less than 100 bp to levels as high as 260 bp (cf. Figure 4).



Considerable regulatory restrictions and the high price of money raised through L.Z. issuance have so far effectively discouraged banks from showing greater interest in this instrument. The main advantage of funding long-term mortgage loans with L.Z., i.e. matching the term structure of the bank's assets and liabilities, was not essential in an era of cheap money from deposits. However, this situation changed sharply as a result of the financial crisis, which led to the introduction of new liquidity standards.

3. L.Z. as a Response to the Liquidity Needs of the Polish Banking Sector

In 2010, in parallel to the work conducted by the Basel Committee, the European Commission presented proposed amendments to the Capital Requirements Directives (CRD) 2008/48 and 2008/49 whose purpose was to eliminate major irregularities in the operation of the financial system that had been identified during the recent financial crisis. Taking into account the liquidity crisis that occurred in 2008 and 2009, the EC suggested, *inter alia*, that new liquidity measures be introduced: the short-term Liquidity Coverage Requirement (LCR) and the long-term Net Stable Funding Requirement (NSFR). The standards proposed differed slightly from the limits in force in Poland pursuant to the requirements of Polish Financial Supervisory Authority Resolution No. 386/2008, since while the Polish **short-term** liquidity ratio requires that the bank's liquidity reserves (primary and supplementary reserves) cover the funds that have been considered unstable by the bank, and in determining this level, the institution uses its own analyses approved by the supervisory authority, in the case of the LCR the level of funds that may be considered non-liquid in a stress scenario is a fixed value.

With respect to the **long-term** liquidity measure, Polish regulations require that the following limits are observed:

- the coverage ratio of non-liquid assets with own funds – calculated as the ratio of the bank's own funds less the total value of capital requirements arising from market risk, settlement/delivery risk and counterparty risk to non-liquid assets;
- the coverage ratio of non-liquid assets and limited liquidity assets with own funds and stable external funds – calculated as the ratio of the Bank's total own funds less the total value of capital requirements related to market risk, settlement/delivery risk and counterparty risk plus stable external funds to total non-liquid assets and limited liquidity assets

– must amount to at least 1.

On the other hand, the NSFR standard proposed by the EC is intended to ensure stable funding for an institution for one year under a shock scenario involving limited access to market funding. Under the NSFR, liquidity depends on asset maturity – different asset groups must be covered by stable funds to differing extents. As opposed to draft European requirements, Polish standards do not impose a direct obligation to balance assets and liabilities with maturities > 1 year.

The problem of the Polish financial sector is a structural liquidity mismatch resulting from the funding strategies employed by banks. As at the end of March 2013, 61% of banks active in the market pursued a funding strategy based on deposits, 11% chose a strategy based on foreign funding and 28% employed a mixed strategy.[5] At the same time, there has been a clear increase in the share of the local deposit base in the banks' funding structure. Therefore, despite the fact that the Polish banking sector meets domestic short-term (M1 and M2) and long-term (M4) liquidity requirements, only ca. 76–85% of the original NSFR standard level would be reached in Poland.[6]

In order to supply long-term funding capital, the share of long-term debt securities in the funding of Polish banks will have to be increased – currently it is ca. 2% of their total assets (compared to ca. 14% in the euro zone). It should also be stressed that since 2011, the growth in mortgage loans in Poland has slowed down, which has partly been the result of softening demand and a decrease in the availability of housing loans, but on the other hand this phenomenon improves the match between the assets and liabilities of the banking sector. If there is an increase in demand for housing loans while stricter liquidity standards are in force, it will be necessary to provide banks with additional long-term capital. L.Z.[7] are precisely the kind of instrument that meets the liquidity and long maturity criteria in this context (they are considered liquid assets pursuant to Article 416, para. 2 CRR).

It should be noted here that the final text of the Capital Requirements Regulation (CRR) slightly relaxed the original requirements concerning the provision of long-term liquidity. The current version of the CRR includes strict regulations on liquidity coverage

[5] *Raport o stabilności systemu finansowego* [Financial Stability Report], Narodowy Bank Polski, July 2013, p. 72.

[6] *Stanowisko NBP do dokumentu konsultacyjnego Komisji Europejskiej „Possible further changes to Capital Requirements Directive*" [NBP position on the European Commission "Possible further changes to Capital Requirements Directive" consultation document], p. 3, http://www.nbp.pl/home.aspx?f=/systemfinansowy/mou/konsultacje.html

[7] Bonds within the meaning of Article 52, para. 4 of the UCITS Directive. Polish instruments meet the requirements of the UCITS Directive.

under gravely stressed conditions over a period of thirty days (Article 412 CRR),[8] and with respect to ensuring so-called stable funding, only the following requirement has been introduced so far: “Institutions shall ensure that long term obligations are adequately met with a diversity of stable funding instruments under both normal and stressed conditions” (Article 413 CRR).

By 31 December 2015, the EBA shall report to the EC “whether and how it would be appropriate to ensure that institutions use stable sources of funding, including an assessment of the impact on the business and risk profile of institutions established in the Union or on financial markets or the economy and bank lending, with a particular focus on … pass through financing models, including match funded mortgage lending” (Article 510 CRR). By 31 December 2016, the Commission shall in turn submit a legislative proposal to the European Parliament and the Council on how to ensure that institutions use stable sources of funding. This, however, does not change the fact that the introduction of regulations on liquidity stability is inevitable, and after their introduction the demand for long-term funding instruments will increase, so it is necessary to take action now in order to stimulate this demand.

4. Stimulating Demand for Polish L.Z. – the Need to Improve Perception of Rating Agencies

Polish L.Z. ratings are assigned by the Fitch (BRE BH and Pekao BH issues) and Moody’s (BRE BH issues) rating agencies. Each agency stresses slightly different aspects of L.Z. issuance, which is reflected in their final ratings of individual issues.

The rating methodology followed by **Moody’s** involves two stages. First, the value of expected loss is estimated, taking into account primarily the standing of the issuer but also the value of the cover pool in the event of the bank’s bankruptcy. The main factors that may affect the value of the cover pool include: (i) the quality of the collateral included in the pool; (ii) funding risk in the event of the issuer’s default (Moody’s requires that cash flows from the assets backing the issue be sufficient to satisfy the investors’ claims over 5 years; moreover, it is usually assumed that funding risk concerns 50% of assets in the cover pool); (iii) interest rate / foreign exchange risk to which the cover pool is exposed – the following factors are primarily taken into account: the volatility of interest rates / exchange rates, the size of the asset pool exposed to the aforementioned risks, the average duration of asset exposure to the aforementioned risks (in the case of the issuer’s default, this is assumed to equal 5 years).

All of the aforementioned factors are subject to a stress test conducted under the assumption of the issuer’s default. The credit quality of the cover pool is measured by determining the collateral score value, which reflects the degree of deterioration in the credit quality of assets in the cover pool in the event of the issuer’s default (the higher the quality of the cover pool, the lower the collateral score).

The second stage of Moody’s determination of the L.Z. rating involves determining the Timely Payment Indicator, i.e. the probability that the investor will receive payments in

[8] This requirement is to be in force as of 1 January 2015, and institutions are expected to achieve at least 60% of the target level in 2015. The threshold will be raised by 10 percentage points each year until it reaches 100% in 2018.

the event the issuer of L.Z. is declared bankrupt. TPIs range from “very high” to “very improbable”.

The rating methodology used by **Fitch** involves three stages and focuses on the probability of default (PD), while also attaching considerable importance to the period following the issuer’s default. In this context, a default is defined by the agency as the moment when payments under the covered bonds are not made in whole or in part.

The first step of determining the rating is the measurement of the D-Factor (Discontinuity Factor), which expresses, on a scale from 0 to 100, the likelihood of an interruption in payments under a covered bond issue in the event of the issuer’s bankruptcy. The D-Factor is 0 in the optimum situation, i.e. “perfect continuity of payments”, and 100 for a “concomitant default of the issuer and its L.Z.”. Further, during the cash flow modelling stage, the agency examines cash flows in conjunction with the quality of backing assets and their ability to sustain payments under L.Z. (also taking the level of overcollateralisation into account). The last stage of the rating process is the determination of recovery rates, i.e. the evaluation of the maximum rating based on PD analysis. At this point, Fitch also takes into account the expected recovery rate; on this basis, the rating may be raised by two to three notches above the grade resulting from the PD calculation.

In general, it should be stressed that in the assessment of L.Z., three issues are considered: the rating of the instrument itself, issuer rating and the rating of the country in question. As a rule, the rating of the financial instrument cannot be higher than the rating of the relevant financial institution, but the quality and safety of L.Z. are reflected by the fact that the rating assigned to L.Z. may exceed the issuer’s rating by one notch. However, the rating of L.Z. (just as that of the issuer) continues to be capped by the sovereign rating level (in the case of Poland: A/A2).

The maximum rating of Polish L.Z. issues is AAA (LC, Fitch) / Aa3 (LC, Moody’s). Given the maximum rating level available, improving the regulatory environment could raise their rating (in local currency) by six (Fitch) or two (Moody’s) notches. This should in turn reduce the cost of loan funding by at least 50–60 basis points.

5. Changes in L.Z. Legal Infrastructure – the Key for High L.Z. Rating

It must be admitted that the legal solutions regarding protection of Polish L.Z. in case of issuer’s insolvency remain to some extend a grey zone. Many questions, which are asked by investors, analysts and rating agencies cannot be clearly answered on a sufficient level by law. That is why improvements to the legal regulations are recommended. Both timely payment and over-indebtedness issues must be taken into account, when looking for solutions. Any over-indebtedness of the cover pool would mean that – according to the actual legislation – the risk of losses on cover assets concentrated on L.Z. with the longest maturities (time subordination) cannot be avoided. That problem must be definitely addressed by a new regulation. Timely payment of hard-bullet L.Z., after a mortgage bank insolvency (which according to the current insolvency law is the rule) cannot be guaranteed if the case of liquidity mismatch occurs. That is why convinced recommendation assumes introducing soft – bullet structure and conditional pass through mechanism into the law. After the implementation of the new Covered Bonds legislation in Belgium, the banks issued new Covered Bonds: (i) Belfius Bank was the first issuer in November 2012, issuing EUR 1,25 bn of 5-year bonds at MS+45 bps (Rating AAA S&P and AAA Fitch); (ii) KBC followed in

December 2012 with a 5-year bond at MS+30 bps (Rating Aaa Moodys and AAA Fitch); (iii) BNP Fortis is planning to issue in similar type as well. Those good ratings prove that soft-bullet structures are highly esteemed by rating agencies.
Therefore, the Strategic Group for Mortgage Banks and Listy Zastawne (the Mortgage Credit Foundation, the Polish mortgage banks their mother banks and bank applying for the mortgage bank licence) recommends to make insolvency proceedings rules concerning mortgage banks after declaring bankruptcy more precise and flexible. In particular the following recommendations and solutions have been addressed to the regulator.

1. **Statutory overcollaterisation and liquidity buffer**

A statutory overcollateralization (OC) of min. 10% should be introduced in the Mortgage Banks and Cover Bonds Act (art 18). That would apply to all kind of covered bonds (L.Z.), be calculated on nominal basis regarding the capital amount of outstanding L.Z. Additionally the new law should implement a rule under which part of the OC would be composed of liquid assets (e.g. central bank eligible bonds), in order to ensure preparation of liquidity buffer. It is assumed that value of this liquid assets (liquidity buffer) would ensure full and timely payment of the interest on the L.Z. due in the upcoming 12 months. The liquid assets for this calculation would be measured at their market value.

Simultaneously, provisions in the insolvency law will statute that in the first year of insolvency, liquidity buffer will be immediately used to ensure timely payment of interests (while maturities of L.Z. principal are postponed automatically by statutory law 1 year further). That solution is to answer the negative assumption of rating agencies, that it is very unlikely that a timely payment of L.Z. could be ensured, if a Polish mortgage bank goes insolvent[9].

2. **Solution skipping commingling and set off risk**

Polish insolvency law already clearly express the bankruptcy privilege for the owners of L.Z. (Art. 442 insolvency law[10]) as well as creation of separate mass. Still for the full transparency it is recommended to regulate expressis verbis that any cash flow on cover assets belongs automatically to a cover pool after insolvency of a mortgage bank (following the new Belgium CB law). The wording of the key Art. 442 of Insolvency Law would additionally clearly state: "If bankruptcy of a mortgage bank is declared, the claims, rights and means,... recorded in the L.Z. cover register, as well as the receivables of the bank on account of repayment of these claims or receivables in connection with capitalisation of the mortgage collateral or other collaterals included in the register, shall constitute a separate bankruptcy estate, which shall serve in the first place to satisfy the claims of mortgage bond creditors...".

3. **Solution skipping the risk of timely subordination list zastawny (with the longest maturity), liquidity gap and default of list zastawny in the insolvency situation**.

---

[9] see: *Continuity Analysis of the Polish Covered Bonds Framework*, Fitch Ratings, raport dated 12.2.2013: „The D-Cap of 0 is driven by the full discontinuity risk assessment of the liquidity gap …“.
[10] The Law on Bankruptcy and Reorganization of 28 February 2003, Journal of Laws of 2003, No 60, item 535, as amended.

This goal is recommended to be achieved by creation of a statutory soft-bullet-structure in case of a mortgage bank insolvency, conditional pass-through payments, as well as detailed regulated scenario for insolvency procedure with clear competences and precise legal tools for action including over-indebtedness and liquidity tests. It should be regulated that since the opening of the insolvency procedure of a mortgage bank, the following process will be followed:

I. Maturities of all L.Z. principal are postponed automatically by statutory law 1 year further. During this period all interest payments are executed pursuant to the terms and conditions of the L.Z. from the mandatory liquidity buffer (part of OC). Period of maturity postponing will be rewarded by initial or different interest if announced in the issuance conditions.
II. As a next step, 2 tests shall be ordered by insolvency administrator (conducted by professional auditor): the over-indebtedness and liquidity tests which results will determine the next steps. Results of these tests shall be validated by responsible authority. In particular:
    a) tests' formulas will be previously defined by FSA,
    b) tests shall be performed at the moment ensuring acceptance of the further way of proceedings within a year following the mortgage bank bankruptcy declaration and repeated: liquidity test – monthly, over-indebtedness test – semi-annually
III. Based on the two tests results, the following „bottom line" procedure should be commenced automatically (by statutory law):
    a) if the over-indebtedness test is failed – all L.Z. are due to pay, but rights of all L.Z. holders become equal, division of sources proceeds on a pari-passu basis (time-subordination problem do not occurs),
    b) if the over-indebtedness test is passed, then:
        - if the liquidity test is passed as well – all payments are executed according to L.Z. terms and conditions („original schedule"),
        - if the liquidity test is failed:
            - all principal payments of L.Z. are postponed till the longest cover pool asset maturity plus 3 yrs (bullet principal payment) – „extension";
            - pass-through structure is applied;
            - the possibility of early repayment of L.Z. according to L.Z. terms and conditions (pari-passu) is in place (mandatory cash-sweep of the cover pool proceeds above semi-annual interest and costs of the cover pool administration);

The above procedure may be discontinued upon bondholders meeting decision, however in the limited scope - it should be regulated that insolvency administrator may arrange L.Z. holders meetings in order to decide (decisions should be taken by the qualified majority, eg. 2/3 of the total debt amount) on: on a possible change of the schedule of payments from the mortgage bonds, on a consent to their partial redemption, the manner of interest calculation or a consent to the sale in whole of the fund covered by the mortgage bonds covered register, stating the acceptable value discount, if there occur the prerequisites, referred especially to the situation where the over-indebtedness test is not passed.

At the same time the possibility that a single L.Z. holder can arrange acceleration (immediate redemption under the Bonds Act) of all L.Z. or all of the same series, if any payment on his L.Z. is not done timely (cross default clause) should be excluded. Terms and conditions should exclude the acceleration option. The final order and way how to distribute the sources form the separate insolvency mass could be as followed:

The following shall be satisfied from the separate bankruptcy estate in the order given below:

1. The costs of management by the insolvency administrator of the separate estate, including the remuneration of the insolvency administrator and the cost of conducting two tests
2. Interest (coupons) on mortgage bonds during the first 12 months from bankruptcy declaration, from funds recorded in the mortgage bonds cover register on account of the liquidity buffer).
3. In the period following the lapse of 12 months from bankruptcy declaration, the interest (coupons) on mortgage bonds and receivables of mortgage bondholders at their nominal value, on their due dates in accordance with the issue conditions, (plus postponement of the schedule by 12 months) if the two tests were passed .
4. In case, when over-indebtedness test is passed, the liquidity test failed) first of all the interest (coupons) on the mortgage bonds shall be satisfied (in accordance with the issue conditions, (-postponement of the schedule by 12 months); if the excessive cover test and liquidity test calculations show a surplus of financial receipt on account of receivables due to assets included in the mortgage bonds cover register over the sum of the planned payments, equal at least to the sum of the interest due calculated for the next 6 months (cash sweep) – also the receivables of the mortgage bondholders shall be satisfied according to their nominal value (capital), subject to the principle of inclusion of all the mortgage bondholders, (regardless of the due date of their receivables) in one satisfaction category, pro rata, and the distribution of funds to satisfy the nominal value of the mortgage bonds as soon as the funds included in the aforesaid surplus calculation are received. (pass through and pari passu; no “subordination” risk).
5. Also in the case of liquidation /selling the whole separate insolvency mass, satisfaction of the mortgage bondholders on interest and capital, shall take place in one satisfaction category, pro rata, and the distribution of funds to satisfy the nominal value of the mortgage bonds as soon as the funds included in the aforesaid surplus calculation are received. (pass through and pari passu; no “subordination” risk).

By introducing into the law the changes mentioned above, it will be achieved, that the following risk concerns will be covered: timely payment of L.Z. after their issuer goes insolvent will be guaranteed (using liquidity buffer), long-term cover assets mismatch with shorter maturities of L.Z. as well as problem in getting additional liquidity from central bank or through fire sales will be covered, e.g. conditional pass-through structure. Key solution and legal response is based, as mentioned above, on introducing ongoing management of coverage sources and equal treatment of all L.Z. holders among their common satisfaction category, following precise rules and transparency of tested liquidity and capital coverage.

With the legal amendments, hopefully the rating of L.Z. will be not anymore so closely linked to the rating of the mortgage bank – and thus closely to the rating of the mother bank and will reach another few notches to get access to the cheaper funding sources form Polish and international capital markets. That is the prerequisite of strong development of LZ market – also for using LZ as a funding tool for the mortgage portfolio in the strategy of banking capital groups.

To fulfil the above recommendations, it is additionally required to make transfer of mortgage pools to the L.Z. issuer more efficient. Very recommended solution would be to get an electronical support for registration into perpetual books. Package of legal improvements in that matter (which was addressed to the regulator) contains of right of applying for change of mortgagee in a perpetual book via electronic channels. Considering the fact, that the perpetual books in Poland have already been electronised, and the reform allowing the notaries to make application on-line is under way, hopefully it is just a next step to enable that the package of applications to disclose mortgage bank as a new mortgagee of transferred mortgage pool – would be conducted electronically.

Above legal changes and new strategies of banking groups could finally change the share of Polish L.Z. on the market. Assuming that the current growth of residential lending will be maintained, 20% of the new mortgage production will be funded with L.Z., and starting from 2014, three banking groups (BRE Bank S.A., Pekao Bank S.A. and PKOBP S.A.) will issue L.Z. - the new issuances of Polish *list zastawny* could amount to 4 billion zlotys per year. That could uplift the share of L.Z. in residential market funding to estimated 10% (from around 1% - see figure 2) and greatly improve the perception of the Polish *list zastawny* – from both investors' and rating agencies' point of view.

dr Agnieszka Tułodziecka
Agnieszka Nierodka

Polish Mortgage Credit Foundation

The institutional framework for the functioning of covered bonds (list zastawny - L.Z.) in Poland was established already in 1997 and first issues took place in 2000; by 2013, L.Z. accounted for a few percent of property market funding, mostly with respect to commercial property. The latest liquidity limits introduced by the requirements of Basel III and of the Capital Requirements Directive / Regulation (CRD / CRR4) will persuade banks to show greater interest in long-term funding instruments to some extent, but in order to improve the L.Z. system in Poland more comprehensively, further changes to the legal environment are necessary so as to achieve significantly better ratings compared to unsecured bonds. The adjustment of the mortgage banking business model that assumes a synergy between the credit policy and the policy for funding mortgage portfolios with L.Z. within groups will also be of essential importance.

The direction of systemic solutions represented by the Polish L.Z. and the quality of the collateral provided by safe assets are commensurate with the expectations of investors who tend to be wary following the sub-prime crisis. The key issue will be to achieve a larger issuance scale as well as to ensure market liquidity. The authors of this analysis express their opinion on success factors in the Polish market environment.

1. Legal Framework for L.Z. Issuance in Poland.

Foundations for the development of the Polish L.Z. market were laid in 1997 when the Act on Covered Bonds and Mortgage Banks (ACBMB) was adopted. In this manner, after more than fifty years, legal grounds for issuing L.Z. and the operation of mortgage banks were restored in Poland.[1]

Pursuant to the Act, the only entities authorised to issue L.Z. are mortgage banks incorporated as joint stock companies. In order to minimise the risk associated with their operations, the list of activities which mortgage banks are authorised to engage in has been limited to only include low-risk activities. The basic activity of mortgage banks consists of granting loans secured by mortgages and issuing <u>L.Z.</u> on this basis as well as of granting loans to public entities set forth in the Act and issuing <u>public L.Z.</u> on this basis. Moreover, pursuant to Article 15 of the ACBMB, a mortgage bank may, within a specified scope, engage in the following additional activities: (i) accept time deposits; (ii) take out loans; (iii) issue bonds; (iv) safekeep securities; (v) purchase and take up shares in other entities whose legal form ensures that the liability of the mortgage bank is limited to the amount of assets invested; (vi) maintain bank accounts used for the servicing of investment projects carried out using loans granted by the mortgage bank; (vii) provide consulting and advisory services related to the property market, including with respect to the determination of the mortgage lending value of property.

The ACBMB imposes a number of rules that limit the risk associated with mortgage bank operations, possibly even at the expense of achieving higher profits. The Act also

[1] Before World War II, L.Z. were issued under the Regulation of the President of the Republic of Poland of 17 March 1928 on Banking Law (Journal of Laws [Dz. U.] No. 34/1928 item 321). The long-term loan (used by issuers of L.Z.) was abolished in 1948 (cf. Decree of 25 October 1948 on the principles and procedures of abolition of some types of long-term loans, Journal of Laws [Dz. U.] No. 52/1948 item 411 and Decree of 25 October 1948 on the banking reform, Journal of Laws [Dz. U.] of 1951 item 279).

contains a number of provisions that ensure the security of the L.Z. itself, which include in particular making the possibility of issuing such securities conditional on meeting statutory conditions and subjecting such activities to strict supervision. These provisions concern: ensuring solvency, which is essentially guaranteed by the principle limiting the total amount of L.Z. outstanding (Article 17 of the Act) and the principle of congruence between interest costs and income, and additionally the principle of ongoing cover for L.Z. (Article 18 of the Act) and the limit on refinancing with L.Z. (Article 14 of the Act).

Summing up, the rules governing the operation of mortgage banks in Poland make the cost of their activities relatively high, but at the same time such activities are highly secure. This, however, does nothing to change the fact that, despite good regulations and a high level of safety provided by L.Z., the market for L.Z. in Poland has not developed significantly during the last 13 years.

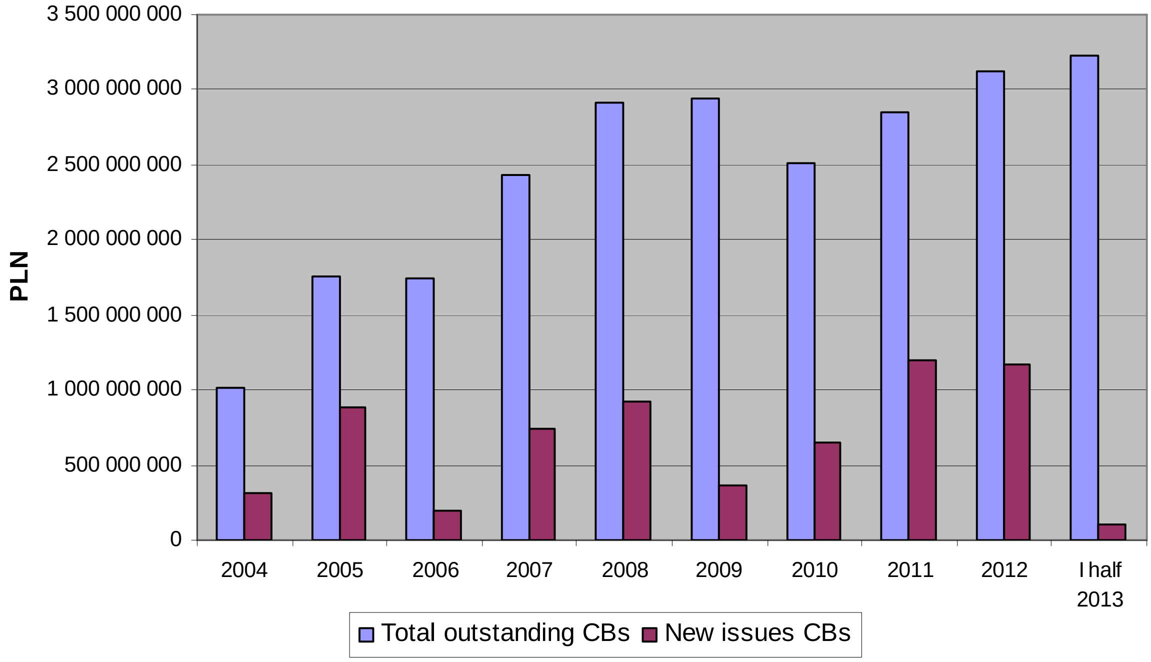
2. Development of the L.Z. Market in Poland

The first post-war issue of L.Z. took place in 2000, but in fact the market only began to operate in a meaningful way from 2005 onwards. Initially, only L.Z. were present on the market; from 2008 onwards, the issuance of public L.Z. commenced as well. L.Z. were issued by three specialised banks: BRE Bank Hipoteczny, Pekao Bank Hipoteczny and Śląski Bank Hipoteczny/ ING Bank Hipoteczny (the last one operated until October 2011).

Currently, two issuers are active on the Polish market: BRE BH accounts for about 70% of the market, while Pekao BH services the remaining 30%. As at end June 2013, total liabilities incurred by mortgage banks arising from the issuance of L.Z. exceeded PLN 3.22 billion, of which L.Z. accounted for ca. PLN 2,766 million and public L.Z. for ca. PLN 455 million.[2]

[2] Data on L.Z. issuance (in annual terms) are published on the website of the Polish Mortgage Credit Foundation (Fundacja na rzecz Kredytu Hipotecznego): http://fundacja1.home.pl/ehipoteka/pol/Statystyki/Listy-zastawne

Figure 1. Covered bonds in Poland



source: Polish Mortgage Credit Foundation

On the market, issues denominated in Polish zloty prevail, which amount to ca. PLN 100–250 million each[3] (the still poor development of the L.Z. system in Poland is reflected by the fact that no Jumbo issues[4] have been conducted so far, which is a major shortcoming of this market, especially for institutional investors). Maturities of Polish L.Z. range from 3 to 7 years; there was a noticeable reduction in those periods when the financial crisis struck with full force (2008–2009), but now – in better economic climate and given increased confidence in the interbank market – most L.Z. are issued for 6 or 7 years and investors hold them until maturity (there is virtually no secondary market in Polish L.Z.).

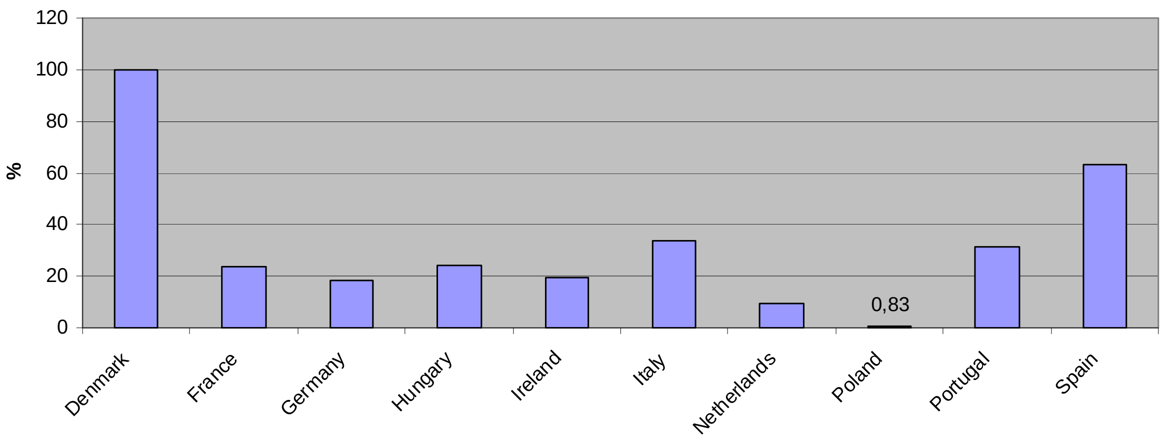
It should be stressed that, in contrast to European trends where about 70% of covered bonds issued are fixed-rate securities, Polish L.Z. are generally floating-rate ones (although in July 2013, BRE BH issued 7-year L.Z. denominated in EUR with a fixed interest rate). This composition of L.Z. corresponds to the characteristics of the Polish mortgage loan portfolio in which variable-rate loans clearly dominate. It should also be pointed out that while the reference rate for mortgage loans denominated in PLN is the WIBOR 1M or 3M, in the case of L.Z. the reference rate is WIBOR 6M, which adversely affects yields in the case of sudden changes in the interbank market (increases in spreads between rates).

[3] All data on L.Z. issuance characteristics are based on the figures provided by mortgage banks to the Polish Mortgage Credit Foundation.
[4] An issue of the order of EUR 500 to 1,000 million.

Share of L.Z. in portfolio funding

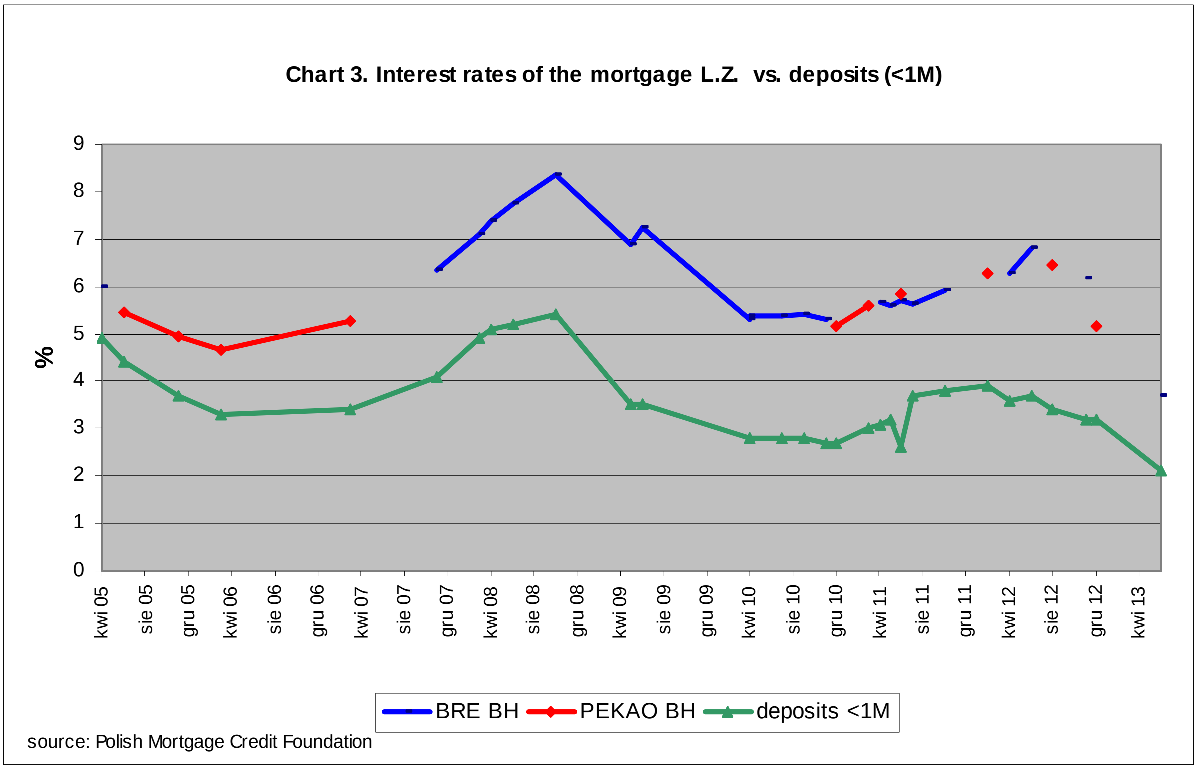
Despite the clear development of the market, which has taken place in recent years, the funding of mortgage portfolios with L.Z. is not yet sufficiently well developed in Poland. Less than 1% of the residential loan portfolio is currently refinanced through L.Z., while e.g. in Hungary this ratio has exceeded 20%, and in the Czech Republic it is higher than 40% (cf. Figure 2). **The average share of covered bonds in funding of European residential markets is about 25%**, which indicates the still-present potential for the development of this instrument in Poland.

Figure 2. Share of covered bonds in residential loans' funding (2012)



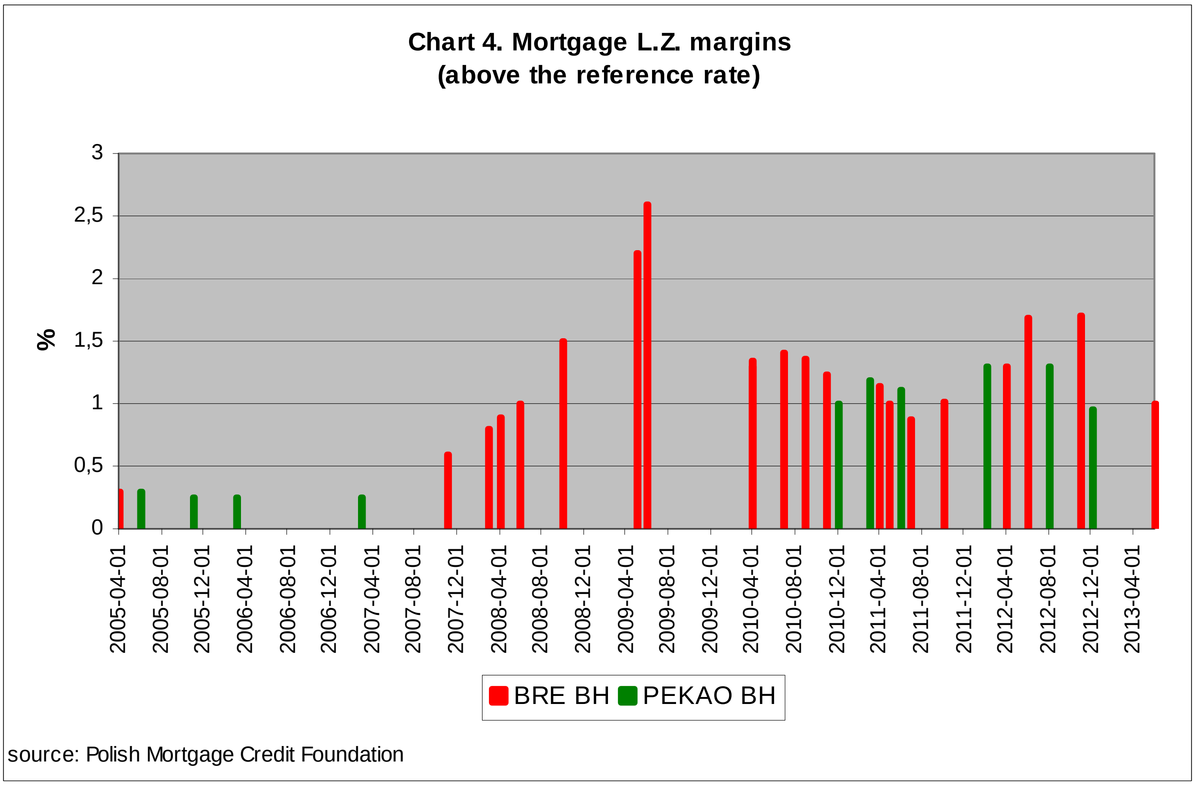
source: Polish Mortgage Credit Foundation

The low share of L.Z. in mortgage portfolio funding in Poland results from economic considerations as well as the absence of systemic incentives that could mitigate the high (compared to deposits) price of capital raised through the issuance of L.Z. One should also point to the strict credit standards applied by mortgage banks and the excess liquidity observed until recently in the sector, which discouraged the use of L.Z. Having easy access to cheap deposits and subordinated loans from their parent companies, banks had no incentive whatsoever to use long-term funding instruments (cf. Figure 3). At the same time, the conditions in which mortgage banks operated meant that their loan offerings could not really compete against those of universal banks, which was, among other things, due to the specialised banks' inability to take retail deposits, more stringent credit limit conditions, the requirement to use mortgage lending appraisals when estimating the value of collateral, etc. While subject to the above limitations on their own business, mortgage banks could not cooperate effectively with universal banks by issuing L.Z. on the basis of the loans granted by universal banks, since this was prevented by problems with the transfer of mortgage claims and the fact that this business model was absent from corporate strategies.



Another factor which impacted the competitiveness of the mortgage banks' offering was the fact that pursuant to Article 18, para. 2 of the ACBMB, the mortgage bank's income from interest on its mortgage-secured claims cannot be lower than the cost arising from the interest on outstanding L.Z., and these limits must be supervised by the trustee and reported to the Polish Financial Supervision Authority. Given the fact that in order to attract demand for Polish L.Z., issuers had to offer relatively high margins, the need to balance the mortgage bank's cost and income related to the issuance of L.Z. made the mortgage loans offered by such banks even more expensive. This has been yet another factor limiting their activities and contributing to the relatively small scale of L.Z. issuance.

It is worth emphasising that the aforementioned problem was exacerbated especially at the peak of the financial crisis and during the credit crunch when L.Z. margins over and above the reference rate jumped from less than 100 bp to levels as high as 260 bp (cf. Figure 4).



Considerable regulatory restrictions and the high price of money raised through L.Z. issuance have so far effectively discouraged banks from showing greater interest in this instrument. The main advantage of funding long-term mortgage loans with L.Z., i.e. matching the term structure of the bank's assets and liabilities, was not essential in an era of cheap money from deposits. However, this situation changed sharply as a result of the financial crisis, which led to the introduction of new liquidity standards.

3. L.Z. as a Response to the Liquidity Needs of the Polish Banking Sector

In 2010, in parallel to the work conducted by the Basel Committee, the European Commission presented proposed amendments to the Capital Requirements Directives (CRD) 2008/48 and 2008/49 whose purpose was to eliminate major irregularities in the operation of the financial system that had been identified during the recent financial crisis. Taking into account the liquidity crisis that occurred in 2008 and 2009, the EC suggested, *inter alia*, that new liquidity measures be introduced: the short-term Liquidity Coverage Requirement (LCR) and the long-term Net Stable Funding Requirement (NSFR). The standards proposed differed slightly from the limits in force in Poland pursuant to the requirements of Polish Financial Supervisory Authority Resolution No. 386/2008, since while the Polish **short-term** liquidity ratio requires that the bank's liquidity reserves (primary and supplementary reserves) cover the funds that have been considered unstable by the bank, and in determining this level, the institution uses its own analyses approved by the supervisory authority, in the case of the LCR the level of funds that may be considered non-liquid in a stress scenario is a fixed value.

With respect to the **long-term** liquidity measure, Polish regulations require that the following limits are observed:

- the coverage ratio of non-liquid assets with own funds – calculated as the ratio of the bank's own funds less the total value of capital requirements arising from market risk, settlement/delivery risk and counterparty risk to non-liquid assets;
- the coverage ratio of non-liquid assets and limited liquidity assets with own funds and stable external funds – calculated as the ratio of the Bank's total own funds less the total value of capital requirements related to market risk, settlement/delivery risk and counterparty risk plus stable external funds to total non-liquid assets and limited liquidity assets

– must amount to at least 1.

On the other hand, the NSFR standard proposed by the EC is intended to ensure stable funding for an institution for one year under a shock scenario involving limited access to market funding. Under the NSFR, liquidity depends on asset maturity – different asset groups must be covered by stable funds to differing extents. As opposed to draft European requirements, Polish standards do not impose a direct obligation to balance assets and liabilities with maturities > 1 year.

The problem of the Polish financial sector is a structural liquidity mismatch resulting from the funding strategies employed by banks. As at the end of March 2013, 61% of banks active in the market pursued a funding strategy based on deposits, 11% chose a strategy based on foreign funding and 28% employed a mixed strategy.[5] At the same time, there has been a clear increase in the share of the local deposit base in the banks' funding structure. Therefore, despite the fact that the Polish banking sector meets domestic short-term (M1 and M2) and long-term (M4) liquidity requirements, only ca. 76–85% of the original NSFR standard level would be reached in Poland.[6]

In order to supply long-term funding capital, the share of long-term debt securities in the funding of Polish banks will have to be increased – currently it is ca. 2% of their total assets (compared to ca. 14% in the euro zone). It should also be stressed that since 2011, the growth in mortgage loans in Poland has slowed down, which has partly been the result of softening demand and a decrease in the availability of housing loans, but on the other hand this phenomenon improves the match between the assets and liabilities of the banking sector. If there is an increase in demand for housing loans while stricter liquidity standards are in force, it will be necessary to provide banks with additional long-term capital. L.Z.[7] are precisely the kind of instrument that meets the liquidity and long maturity criteria in this context (they are considered liquid assets pursuant to Article 416, para. 2 CRR).

It should be noted here that the final text of the Capital Requirements Regulation (CRR) slightly relaxed the original requirements concerning the provision of long-term liquidity. The current version of the CRR includes strict regulations on liquidity coverage

---

[5] *Raport o stabilności systemu finansowego* [Financial Stability Report], Narodowy Bank Polski, July 2013, p. 72.

[6] *Stanowisko NBP do dokumentu konsultacyjnego Komisji Europejskiej „Possible further changes to Capital Requirements Directive*" [NBP position on the European Commission "Possible further changes to Capital Requirements Directive" consultation document], p. 3, http://www.nbp.pl/home.aspx?f=/systemfinansowy/mou/konsultacje.html

[7] Bonds within the meaning of Article 52, para. 4 of the UCITS Directive. Polish instruments meet the requirements of the UCITS Directive.

under gravely stressed conditions over a period of thirty days (Article 412 CRR),[8] and with respect to ensuring so-called stable funding, only the following requirement has been introduced so far: “Institutions shall ensure that long term obligations are adequately met with a diversity of stable funding instruments under both normal and stressed conditions” (Article 413 CRR).

By 31 December 2015, the EBA shall report to the EC “whether and how it would be appropriate to ensure that institutions use stable sources of funding, including an assessment of the impact on the business and risk profile of institutions established in the Union or on financial markets or the economy and bank lending, with a particular focus on … pass through financing models, including match funded mortgage lending” (Article 510 CRR). By 31 December 2016, the Commission shall in turn submit a legislative proposal to the European Parliament and the Council on how to ensure that institutions use stable sources of funding. This, however, does not change the fact that the introduction of regulations on liquidity stability is inevitable, and after their introduction the demand for long-term funding instruments will increase, so it is necessary to take action now in order to stimulate this demand.

4. Stimulating Demand for Polish L.Z. – the Need to Improve Perception of Rating Agencies

Polish L.Z. ratings are assigned by the Fitch (BRE BH and Pekao BH issues) and Moody’s (BRE BH issues) rating agencies. Each agency stresses slightly different aspects of L.Z. issuance, which is reflected in their final ratings of individual issues.

The rating methodology followed by **Moody’s** involves two stages. First, the value of expected loss is estimated, taking into account primarily the standing of the issuer but also the value of the cover pool in the event of the bank’s bankruptcy. The main factors that may affect the value of the cover pool include: (i) the quality of the collateral included in the pool; (ii) funding risk in the event of the issuer’s default (Moody’s requires that cash flows from the assets backing the issue be sufficient to satisfy the investors’ claims over 5 years; moreover, it is usually assumed that funding risk concerns 50% of assets in the cover pool); (iii) interest rate / foreign exchange risk to which the cover pool is exposed – the following factors are primarily taken into account: the volatility of interest rates / exchange rates, the size of the asset pool exposed to the aforementioned risks, the average duration of asset exposure to the aforementioned risks (in the case of the issuer’s default, this is assumed to equal 5 years).

All of the aforementioned factors are subject to a stress test conducted under the assumption of the issuer’s default. The credit quality of the cover pool is measured by determining the collateral score value, which reflects the degree of deterioration in the credit quality of assets in the cover pool in the event of the issuer’s default (the higher the quality of the cover pool, the lower the collateral score).

The second stage of Moody’s determination of the L.Z. rating involves determining the Timely Payment Indicator, i.e. the probability that the investor will receive payments in

[8] This requirement is to be in force as of 1 January 2015, and institutions are expected to achieve at least 60% of the target level in 2015. The threshold will be raised by 10 percentage points each year until it reaches 100% in 2018.

the event the issuer of L.Z. is declared bankrupt. TPIs range from “very high” to “very improbable”.

The rating methodology used by **Fitch** involves three stages and focuses on the probability of default (PD), while also attaching considerable importance to the period following the issuer’s default. In this context, a default is defined by the agency as the moment when payments under the covered bonds are not made in whole or in part.

The first step of determining the rating is the measurement of the D-Factor (Discontinuity Factor), which expresses, on a scale from 0 to 100, the likelihood of an interruption in payments under a covered bond issue in the event of the issuer’s bankruptcy. The D-Factor is 0 in the optimum situation, i.e. “perfect continuity of payments”, and 100 for a “concomitant default of the issuer and its L.Z.”. Further, during the cash flow modelling stage, the agency examines cash flows in conjunction with the quality of backing assets and their ability to sustain payments under L.Z. (also taking the level of overcollateralisation into account). The last stage of the rating process is the determination of recovery rates, i.e. the evaluation of the maximum rating based on PD analysis. At this point, Fitch also takes into account the expected recovery rate; on this basis, the rating may be raised by two to three notches above the grade resulting from the PD calculation.

In general, it should be stressed that in the assessment of L.Z., three issues are considered: the rating of the instrument itself, issuer rating and the rating of the country in question. As a rule, the rating of the financial instrument cannot be higher than the rating of the relevant financial institution, but the quality and safety of L.Z. are reflected by the fact that the rating assigned to L.Z. may exceed the issuer’s rating by one notch. However, the rating of L.Z. (just as that of the issuer) continues to be capped by the sovereign rating level (in the case of Poland: A/A2).

The maximum rating of Polish L.Z. issues is AAA (LC, Fitch) / Aa3 (LC, Moody’s). Given the maximum rating level available, improving the regulatory environment could raise their rating (in local currency) by six (Fitch) or two (Moody’s) notches. This should in turn reduce the cost of loan funding by at least 50–60 basis points.

5. Changes in L.Z. Legal Infrastructure – the Key for High L.Z. Rating

It must be admitted that the legal solutions regarding protection of Polish L.Z. in case of issuer’s insolvency remain to some extend a grey zone. Many questions, which are asked by investors, analysts and rating agencies cannot be clearly answered on a sufficient level by law. That is why improvements to the legal regulations are recommended. Both timely payment and over-indebtedness issues must be taken into account, when looking for solutions. Any over-indebtedness of the cover pool would mean that – according to the actual legislation – the risk of losses on cover assets concentrated on L.Z. with the longest maturities (time subordination) cannot be avoided. That problem must be definitely addressed by a new regulation. Timely payment of hard-bullet L.Z., after a mortgage bank insolvency (which according to the current insolvency law is the rule) cannot be guaranteed if the case of liquidity mismatch occurs. That is why convinced recommendation assumes introducing soft – bullet structure and conditional pass through mechanism into the law. After the implementation of the new Covered Bonds legislation in Belgium, the banks issued new Covered Bonds: (i) Belfius Bank was the first issuer in November 2012, issuing EUR 1,25 bn of 5-year bonds at MS+45 bps (Rating AAA S&P and AAA Fitch); (ii) KBC followed in

December 2012 with a 5-year bond at MS+30 bps (Rating Aaa Moodys and AAA Fitch); (iii) BNP Fortis is planning to issue in similar type as well. Those good ratings prove that soft-bullet structures are highly esteemed by rating agencies.

Therefore, the Strategic Group for Mortgage Banks and Listy Zastawne (the Mortgage Credit Foundation, the Polish mortgage banks their mother banks and bank applying for the mortgage bank licence) recommends to make insolvency proceedings rules concerning mortgage banks after declaring bankruptcy more precise and flexible. In particular the following recommendations and solutions have been addressed to the regulator.

1. Statutory overcollaterisation and liquidity buffer

A statutory overcollateralization (OC) of min. 10% should be introduced in the Mortgage Banks and Cover Bonds Act (art 18). That would apply to all kind of covered bonds (L.Z.), be calculated on nominal basis regarding the capital amount of outstanding L.Z. Additionally the new law should implement a rule under which part of the OC would be composed of liquid assets (e.g. central bank eligible bonds), in order to ensure preparation of liquidity buffer. It is assumed that value of this liquid assets (liquidity buffer) would ensure full and timely payment of the interest on the L.Z. due in the upcoming 12 months. The liquid assets for this calculation would be measured at their market value.

Simultaneously, provisions in the insolvency law will statute that in the first year of insolvency, liquidity buffer will be immediately used to ensure timely payment of interests (while maturities of L.Z. principal are postponed automatically by statutory law 1 year further). That solution is to answer the negative assumption of rating agencies, that it is very unlikely that a timely payment of L.Z. could be ensured, if a Polish mortgage bank goes insolvent[9].

2. Solution skipping commingling and set off risk

Polish insolvency law already clearly express the bankruptcy privilege for the owners of L.Z. (Art. 442 insolvency law[10]) as well as creation of separate mass. Still for the full transparency it is recommended to regulate expressis verbis that any cash flow on cover assets belongs automatically to a cover pool after insolvency of a mortgage bank (following the new Belgium CB law). The wording of the key Art. 442 of Insolvency Law would additionally clearly state: "If bankruptcy of a mortgage bank is declared, the claims, rights and means,... recorded in the L.Z. cover register, as well as the receivables of the bank on account of repayment of these claims or receivables in connection with capitalisation of the mortgage collateral or other collaterals included in the register, shall constitute a separate bankruptcy estate, which shall serve in the first place to satisfy the claims of mortgage bond creditors...".

3. **Solution skipping the risk of timely subordination list zastawny (with the longest maturity), liquidity gap and default of list zastawny in the insolvency situation**.

[9] see: *Continuity Analysis of the Polish Covered Bonds Framework*, Fitch Ratings, raport dated 12.2.2013: „The D-Cap of 0 is driven by the full discontinuity risk assessment of the liquidity gap …".

[10] The Law on Bankruptcy and Reorganization of 28 February 2003, Journal of Laws of 2003, No 60, item 535, as amended.

This goal is recommended to be achieved by creation of a statutory soft-bullet-structure in case of a mortgage bank insolvency, conditional pass-through payments, as well as detailed regulated scenario for insolvency procedure with clear competences and precise legal tools for action including over-indebtedness and liquidity tests. It should be regulated that since the opening of the insolvency procedure of a mortgage bank, the following process will be followed:

I. Maturities of all L.Z. principal are postponed automatically by statutory law 1 year further. During this period all interest payments are executed pursuant to the terms and conditions of the L.Z. from the mandatory liquidity buffer (part of OC). Period of maturity postponing will be rewarded by initial or different interest if announced in the issuance conditions.

II. As a next step, 2 tests shall be ordered by insolvency administrator (conducted by professional auditor): the over-indebtedness and liquidity tests which results will determine the next steps. Results of these tests shall be validated by responsible authority. In particular:
   a) tests' formulas will be previously defined by FSA,
   b) tests shall be performed at the moment ensuring acceptance of the further way of proceedings within a year following the mortgage bank bankruptcy declaration and repeated: liquidity test – monthly, over-indebtedness test – semi-annually

III. Based on the two tests results, the following „bottom line" procedure should be commenced automatically (by statutory law):
   a) if the over-indebtedness test is failed – all L.Z. are due to pay, but rights of all L.Z. holders become equal, division of sources proceeds on a pari-passu basis (time-subordination problem do not occurs),
   b) if the over-indebtedness test is passed, then:
      ▪ if the liquidity test is passed as well – all payments are executed according to L.Z. terms and conditions („original schedule"),
      ▪ if the liquidity test is failed:
         ➢ all principal payments of L.Z. are postponed till the longest cover pool asset maturity plus 3 yrs (bullet principal payment) – „extension";
         ➢ pass-through structure is applied;
         ➢ the possibility of early repayment of L.Z. according to L.Z. terms and conditions (pari-passu) is in place (mandatory cash-sweep of the cover pool proceeds above semi-annual interest and costs of the cover pool administration);

The above procedure may be discontinued upon bondholders meeting decision, however in the limited scope - it should be regulated that insolvency administrator may arrange L.Z. holders meetings in order to decide (decisions should be taken by the qualified majority, eg. 2/3 of the total debt amount) on: on a possible change of the schedule of payments from the mortgage bonds, on a consent to their partial redemption, the manner of interest calculation or a consent to the sale in whole of the fund covered by the mortgage bonds covered register, stating the acceptable value discount, if there occur the prerequisites, referred especially to the situation where the over-indebtedness test is not passed.

At the same time the possibility that a single L.Z. holder can arrange acceleration (immediate redemption under the Bonds Act) of all L.Z. or all of the same series, if any payment on his L.Z. is not done timely (cross default clause) should be excluded. Terms and conditions should exclude the acceleration option. The final order and way how to distribute the sources form the separate insolvency mass could be as followed:

The following shall be satisfied from the separate bankruptcy estate in the order given below:

1. The costs of management by the insolvency administrator of the separate estate, including the remuneration of the insolvency administrator and the cost of conducting two tests
2. Interest (coupons) on mortgage bonds during the first 12 months from bankruptcy declaration, from funds recorded in the mortgage bonds cover register on account of the liquidity buffer).
3. In the period following the lapse of 12 months from bankruptcy declaration, the interest (coupons) on mortgage bonds and receivables of mortgage bondholders at their nominal value, on their due dates in accordance with the issue conditions, (plus postponement of the schedule by 12 months) if the two tests were passed .
4. In case, when over-indebtedness test is passed, the liquidity test failed) first of all the interest (coupons) on the mortgage bonds shall be satisfied (in accordance with the issue conditions, (-postponement of the schedule by 12 months); if the excessive cover test and liquidity test calculations show a surplus of financial receipt on account of receivables due to assets included in the mortgage bonds cover register over the sum of the planned payments, equal at least to the sum of the interest due calculated for the next 6 months (cash sweep) – also the receivables of the mortgage bondholders shall be satisfied according to their nominal value (capital), subject to the principle of inclusion of all the mortgage bondholders, (regardless of the due date of their receivables) in one satisfaction category, pro rata, and the distribution of funds to satisfy the nominal value of the mortgage bonds as soon as the funds included in the aforesaid surplus calculation are received. (pass through and pari passu; no “subordination” risk).
5. Also in the case of liquidation /selling the whole separate insolvency mass, satisfaction of the mortgage bondholders on interest and capital, shall take place in one satisfaction category, pro rata, and the distribution of funds to satisfy the nominal value of the mortgage bonds as soon as the funds included in the aforesaid surplus calculation are received. (pass through and pari passu; no “subordination” risk).

By introducing into the law the changes mentioned above, it will be achieved, that the following risk concerns will be covered: timely payment of L.Z. after their issuer goes insolvent will be guaranteed (using liquidity buffer), long-term cover assets mismatch with shorter maturities of L.Z. as well as problem in getting additional liquidity from central bank or through fire sales will be covered, e.g. conditional pass-through structure. Key solution and legal response is based, as mentioned above, on introducing ongoing management of coverage sources and equal treatment of all L.Z. holders among their common satisfaction category, following precise rules and transparency of tested liquidity and capital coverage.

With the legal amendments, hopefully the rating of L.Z. will be not anymore so closely linked to the rating of the mortgage bank – and thus closely to the rating of the mother bank and will reach another few notches to get access to the cheaper funding sources form Polish and international capital markets. That is the prerequisite of strong development of LZ market – also for using LZ as a funding tool for the mortgage portfolio in the strategy of banking capital groups.

To fulfil the above recommendations, it is additionally required to make transfer of mortgage pools to the L.Z. issuer more efficient. Very recommended solution would be to get an electronical support for registration into perpetual books. Package of legal improvements in that matter (which was addressed to the regulator) contains of right of applying for change of mortgagee in a perpetual book via electronic channels. Considering the fact, that the perpetual books in Poland have already been electronised, and the reform allowing the notaries to make application on-line is under way, hopefully it is just a next step to enable that the package of applications to disclose mortgage bank as a new mortgagee of transferred mortgage pool – would be conducted electronically.

Above legal changes and new strategies of banking groups could finally change the share of Polish L.Z. on the market. Assuming that the current growth of residential lending will be maintained, 20% of the new mortgage production will be funded with L.Z., and starting from 2014, three banking groups (BRE Bank S.A., Pekao Bank S.A. and PKOBP S.A.) will issue L.Z. - the new issuances of Polish *list zastawny* could amount to 4 billion zlotys per year. That could uplift the share of L.Z. in residential market funding to estimated 10% (from around 1% - see figure 2) and greatly improve the perception of the Polish *list zastawny* – from both investors' and rating agencies' point of view.

dr Agnieszka Tułodziecka
Agnieszka Nierodka

Polish Mortgage Credit Foundation