OPINION OF THE EUROPEAN CENTRAL BANK

of 20 March 2015

on the legal framework for covered bonds and mortgage banks

(CON/2015/11)

Introduction and legal basis

On 5 February 2015 the European Central Bank (ECB) received a request from the Polish Ministry of Finance for an opinion on a draft law amending the Law on covered bonds and mortgage banks and certain other laws (hereinafter the 'draft law').

The ECB's competence to deliver an opinion is based on Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union and the sixth indent of Article 2(1) of Council Decision 98/415/EC[1], as the draft law relates to rules applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

1. Purpose of the draft law

1.1 The main purpose of the draft law is to enhance the availability of well-diversified funding sources from capital market investors to the Polish banking sector. This is in order to address the potential threat to the stability of the Polish banking sector caused by maturity mismatches in mortgage financing, primarily based on short-term liabilities such as deposits. The differences in the maturities of their assets and liabilities expose credit institutions to liquidity risks. In addition, the draft law contributes to the preparations by the Polish financial sector to comply with Regulation (EU) No 575/2013 of the European Parliament and of the Council[2] and Directive 2013/36/EU of the European Parliament and of the Council[3], in particular the liquidity coverage and stable funding requirements.

1.2 The draft law seeks to achieve these aims by changing the funding model for mortgage lending through the development of long-term debt instruments. This will enable credit institutions to reduce liquidity shortages due to maturity mismatches and thereby facilitate their compliance with, in particular, regulatory liquidity standards. This could be achieved by developing a market for covered bonds that, while allowing Polish credit institutions to reduce the maturity mismatches, is

1 Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions (OJ L 189, 3.7.1998, p. 42).

2 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

3 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

considered attractive to investors. To ensure a wider use of covered bonds by banks for refinancing purposes, the draft law introduces amendments aimed at eliminating current barriers to the development and the use of such instruments.

1.3 To this end, the draft law amends the Law on covered bonds and mortgage banks of 29 August 1997[4] (hereinafter the 'Law on covered bonds') by:

(a) compelling a mortgage bank to over-collateralise its covered bonds by at least 10% of the issue, and to establish a liquidity buffer in order to secure the payment of interest on covered bonds within a period of 6 consecutive months;

(b) clarifying that a bondholder does not have a statutory or contractual right to redeem the covered bonds prematurely. At the same time, this does not affect the issuer's right to exercise the early redemption of covered bonds;

(c) increasing the limit applicable to residential loans secured by a mortgage from 60% to 80% of the mortgage lending value of a property, for purposes of the issuance of covered bonds;

(d) providing that regular asset coverage and liquidity tests should be performed by mortgage banks as well as authorising the Minister for Finance to further define, in a separate regulation, the specific technical aspects of such tests;

(e) clarifying that the eligibility criteria for a single loan secured by a mortgage (*hipoteka*) does not exceed 100% of the mortgage lending value of a property. This will be calculated at the date of granting or, if a mortgage credit receivable is purchased by the mortgage bank, at the date of purchasing of a given credit, rather than as an ongoing obligation to keep the loan-to-value ratio (LTV) at a maximum level of 100% during the life of mortgage credit;

(f) addressing issues identified with regard to the financing of development projects under construction. The draft law introduces the right for a mortgage bank to request that the relevant court enters a claim for the registration of the mortgage on a property, on which a development project is implemented, even without the prior consent of the relevant developer. The disclosure of this claim is a condition for the disbursement of funds from a loan granted for the purchase of a development property that is under construction. At the same time, there is no change to the principle that covered bonds may be issued in relation to such credit receivables only upon the registration of the mortgage.

1.4 With a view to ensuring the adequate and timely service of bondholders in the event of an issuer's insolvency, thereby securing a more favourable rating agency assessment of the Polish covered bond issuers, the draft law also introduces amendments to the Law on bankruptcy and rehabilitation of 28 February 2003[5] (hereinafter the 'Law on bankruptcy'). The key features of the draft law in this respect include:

(a) a mandatory 12 month extension of the redemption date of all covered bonds. The proposed extension period starts on the date the Polish mortgage bank issuer is declared insolvent;

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4 *Dziennik Ustaw* (Dz. U.) of 2003, No. 99, item 919.

5 Dz. U. of 2012, item 1112.

(b) the introduction of an asset coverage test, which verifies whether the separate insolvency estate is sufficient to fully satisfy the claims of the bondholders on the verification date, and a liquidity test, which verifies whether the separate insolvency estate is sufficient to fully satisfy the claims of the bondholders on the extended redemption dates. The results of these tests are approved by the Polish Financial Supervision Authority and further procedure is determined based on such results;

(c) the clarification of the rules on convening bondholder meetings and voting majorities;

(d) rules on the "earmarking" of funds in a separate insolvency estate;

(e) the clarification that set-off is not permitted, other than in respect of claims arising under hedging transactions, and in respect of settlements processed under a payment or securities settlement system.

1.5 The draft law also eliminates some of the barriers to the development of covered bonds that were present in Polish tax legislation. Namely, it amends the Law on corporate income tax of 15 February 1992[6] and the Law on personal income tax of 26 July 1991[7], by introducing the following measures:

(a) an exception from the tax at source, which would normally need to be withheld by the bonds' issuers on interest paid abroad to entities that are tax residents in jurisdictions other than Poland, but who have a taxable source of income in Poland; and

(b) enabling the mortgage banks to recognise specific provisions, particularly impairment losses, made for receivables arising from credits, which are purchased by them from other banks, in tax deductible expenses and to write-off such receivables as irrecoverable after having documented the inability to recover them. This will ensure the equal treatment of credits granted by mortgage banks and credits purchased by such entities in the area of tax law.

1.6 Additionally, the draft law introduces solutions aimed at facilitating the investment in covered bonds by Polish domiciled pension funds. To this effect, the draft law amends the Law on the organisation and operation of pension funds of 28 August 1997[8] by excluding covered bonds from the subjective limits imposed collectively on a certain group of financial instruments by reducing investments in securities of a single issuer to the level of 10% of a fund's assets, and imposing a single limit of 5% of a fund's assets in relation to covered bonds issued by a single issuer or a group of issuers.

1.7 Finally, the draft law amends the Law on cooperative savings and credit unions of 5 November 2009[9] and enables Polish domiciled credit unions to invest directly and unconditionally in covered bonds. This is justified by the fact that such credit unions, similarly to Polish domiciled commercial banks, are subject to supervision of the Polish Financial Supervision Authority and are covered by the Polish deposit guarantee scheme.

6 Dz. U. of 2014, item 851.

7 Dz. U. of 2012, item 361.

8 Dz. U. of 2013, item 989, 289 and 1717.

9 Dz. U. of 2013, item 1450.

2. General observations

2.1 The ECB broadly welcomes the draft law intended to promote the development of the Polish covered bond market. In particular, the ECB welcomes the envisaged over-collateralisation requirement as a risk mitigation tool and the requirement for regular asset coverage and liquidity tests to be performed by the mortgage banks. At the same time, the Polish authorities may wish to consider the level of the over-collateralisation requirement, taking into account the level of asset encumbrance. Moreover, better-capitalised covered bond issuers typically do not need high levels of over-collateralisation to enhance the creditworthiness of their covered bonds. Hence, providing more flexibility in terms of over- collateralisation may improve the attractiveness of issuing covered bonds particularly for better-capitalised banks.

2.2 The measures included in the draft law may benefit from the solutions included in the Recommendation of the European Systemic Risk Board of 20 December 2012 on funding of credit institutions (ESRB/2012/2)[10], and should be assessed against the recommendations for improving covered bond frameworks set out by the European Banking Authority (EBA) in its Report on EU Covered Bond Frameworks and Capital Treatment, published in July 2014 which defines best practises with regard to, among other things, valuation of mortgage cover assets, LTV criteria, coverage principles and over-collateralisation.

2.3. Given the complexity of the subject matter and the legal framework for covered bonds and mortgage banks in Poland, the draft law would undoubtedly benefit from an explanatory memorandum, explaining in detail the reasoning behind particular amendments and how they relate to each other and to other Polish legislation. The detailed description of the draft law contained in the present ECB Opinion should facilitate the preparation of such explanatory memorandum.

3. Safety thresholds and concentration of secured long-term debt instruments

3.1 The current framework provides for an eligibility threshold where the LTV for a single loan secured by a mortgage may not be higher than 100%. In addition, the law establishes limits on the applicable mortgage lending values for the purposes of the issuance of covered bonds. In this regard, lower ratios increase the resilience of banks and their borrowers to adverse shocks, thereby enhancing the resilience of the financial system as a whole. Hence, given market practices, in certain Member States with active covered bond markets, the threshold is lower than 80% with respect to residential mortgages.

3.2 Coherence of the Polish covered bond laws with European standards and covered bond frameworks that are already in place should support the liquidity of covered bonds issued under the new draft law, thereby further increasing investor interest and contributing to resilience of the Polish covered bond market. The best practises published by the EBA in July 2014 serve as an indicative benchmark to achieve the warranted level of standardisation.

3.3 In order to enhance the clarity of the legal framework, the wording of the existing provisions in the current Law on covered bonds concerning the applicable lending limits for the purposes of the

10 OJ C 119, 25/4/2013, p. 1.

issuance of covered bonds should be made clearer (see, in particular, paragraph 1 of Article 13 of the Law on covered bonds). Moreover, as regards the calculation of the ongoing cover for mortgage covered bonds, we understand that such calculations consider only disbursed amounts and this should be stipulated clearly in the amended Article 18.

3.4 As an additional safeguard, the draft law should include a provision ensuring that the valuation for purposes of determining the mortgage lending values is carried out by an expert who is independent from the credit approval process. As regards the eligibility threshold, the monitoring and updating of the valuation of the collateral assets and the corresponding LTV calculations, at least on an annual basis, could also strengthen the regime.

3.5 In addition to the proposed provisions related to development projects under construction, consideration could be given to the inclusion of a robust mechanism for the valuation of such projects to ensure that the mortgage lending value for the purposes of the covered bond does not exceed the status value of the achieved construction stage, as certified by an independent expert.

4. Amendments to the provisions related to bankruptcy and rehabilitation

4.1 The ECB welcomes the proposed changes to the Law on bankruptcy to the extent that they clarify the treatment of covered bondholders in the event of the issuer's insolvency and therefore provide for more transparency and legal certainty. However, it is noted that the current insolvency regime in Poland may need to be adapted to transpose Directive 2014/59/EU of the European Parliament and of the Council[11] and that a draft of a new restructuring law is currently being considered by the Polish authorities. To this end, the ECB invites the Polish Ministry of Finance to clarify the scope and relationship of the draft law with Directive 2014/59/EU and the proposed provisions of the new restructuring law, in order to ensure a consistent approach to these legislative initiatives.

4.2 The draft law provides for a mandatory automatic extension of the redemption dates of all relevant covered bonds by 12 months with the extension to become effective on the date of declaration of the issuer's insolvency. Notwithstanding any further possible changes to Polish law as a result of the transposition of Directive 2014/59/EU, it should be clarified that the extension is warranted in all circumstances and especially in situations where asset coverage tests and liquidity tests have been performed successfully according to the schedule set out in the law. The ECB understands that it is the intention of the Polish authorities to provide sufficient time for maximum realisation of the value of the cover pool in the event that an issuer is declared insolvent. The ECB welcomes this notion but recommends an optional rather than mandatory process at the discretion of the resolution authority or insolvency practitioner. The minimising of the extension risk could promote a more robust access by mortgage banks to longer-term funding as well as underpin the stability of the asset class for investors. Moreover, the ECB recommends that mortgage banks should be required to put in place appropriate and prudent operational procedures aimed at ensuring an orderly functioning of the covered bond programme upon default or resolution of an issuer.

11 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (OJ L 173, 12.6.2014, p. 190).

4.3 The draft law provides that the amended Article 446c(3) of the Law on bankruptcy will allow a two-thirds majority of bondholders to decide that the pass-through procedure will not apply. However, unlike in the proposed amended Article 446d(1) of the Law on Bankruptcy, the draft law does not specify any alternative measures that may be adopted by bondholders.

This opinion will be published on the ECB's website.

Done at Frankfurt am Main, 20 March 2015.

[signed]

The President of the ECB

Mario DRAGHI