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Briefing note

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Amendment of the act on covered bonds and mortgage banks

The amendment of 24 July 2015 (Journal of Laws of 2015, item 1259) (the "**Amendment**") of the Act on Covered Bonds and Mortgage Banks of 29 August 1997 (consolidated text of 28 April 2003: Journal of Laws no. 99, item 919) (the "**Act**") entered into force on 1 January 2016. The Amendment introduces a number of changes in response to the expectations of the banking sector that facilitate the issue of covered bonds and introduce a number of features to accommodate the purchasers thereof. One of the goals behind the Amendment is to mitigate the liquidity (and the interest rate) risk borne by banks that provide mortgage loans. These risks originate from, among other things, the fact that to date the granting of mortgage loans has been financed primarily with short-term deposits, the maturity of which differs significantly from that of the long-term assets which they finance. Such a situation may result in the risk of the potential loss of liquidity by a bank whose customers decide to withdraw even a relatively small portion of deposits. Increasing the share of covered bonds (which constitute a long-term source of financing) as a new source of capital raised by banks intended to result in the increased security of banks while, at the same time, limit the risk of their insolvency. In addition to the Act on Covered Bonds and Mortgage Banks, the Amendment introduces also changes to other Acts the provisions of which are related to the issue of covered bonds, including tax Acts and the bankruptcy law.

The following acts of law are affected by the Amendment:

- The Act on Covered Bonds and Mortgage Banks of 29 August 1997;
- The Act on Personal Income Tax of 26 July 1991;
- The Act on Corporate Income Tax of 15 February 1992;
- The Act on the Organisation and Operation of Pension Funds of 28 August 1997;
- The Act of 28 February 2003 – Bankruptcy Law;
- The Act on Cooperative Savings and Loan Societies of 5 November 2009;
- The Act of 15 May 2015 – Restructuring Law.

Most important changes

The most important changes introduced by the Amendment include:

- The introduction of new parameters and requirements for mortgage banks as well as setting out in more detail the information requirements for issuers of covered bonds;
- The strengthening of the protection of buyers of covered bonds, including in bankruptcy proceedings by introducing the possibility to satisfy themselves from a separate bankruptcy estate;
- The decreasing of the tax burdens to be borne by buyers of covered bonds;
- The increasing of the liquidity of covered bonds, including by allowing Open Pension Funds (OFE) and cooperative savings and loan societies (SKOK) to trade in these instruments.

Issue limits and over-collateralisation

The Amendment introduces the concept of over-collateralisation, determined in relation to the total nominal amount of the mortgage-backed (as well as public) covered bonds. Formerly, such an amount could not exceed the nominal sum of the receivables constituting the basis for the issue of covered bonds. Pursuant to the Amendment, the total amount of the receivables secured with a mortgage established by a given issuer, receivables against the public sector as well as Other Funds (as defined below), increased by the value of purchased financial hedging instruments (i.e. serving to mitigate the risk related to the assets or liabilities of the mortgage bank and compliant with the requirements set out in the Accounting Act of 29 September 1994), should amount to not less than 110% of the total amount of the outstanding mortgage-backed covered bonds of that issuer (over-collateralisation amounting to 10%). In short, this means that each PLN 100 of the nominal sum of the issued covered bonds must be covered with at least PLN 110 of funds constituting the basis of the issue. This solution applies to both mortgage-backed and public covered bonds, and its purpose is to further limit the liquidity risk of the mortgage bank through the creation of a capital buffer.

By contrast, following the Amendment, there are no limitations regarding an issue made on the basis of (i) the spare funds of a mortgage bank (e.g. the cash held by such bank), (ii) securities issued or guaranteed by public sector institutions referred to in the Act, as well as (iii) the funds deposited with the National Bank of Poland (together the "**Other Funds**").. Previously own funds of the mortgage bank could constitute a basis for the issue only up to 10% of the amounts of the mortgage-backed receivables of the relevant mortgage bank.

Liquidity reserve

In addition, mortgage banks will be obliged to maintain a liquidity surplus corresponding to at least 6-months' nominal interest on outstanding covered bonds (the "**Liquidity Reserve**"). The purpose of this buffer is to secure the servicing of the covered bonds that will mature within the 6 months following their issue date. This is to result in a greater security of payments to the holders of the given securities before their maturity. The funds designated for the Liquidity Reserve are

subject to registration in the register of securities for covered bonds and may not form the basis for an issue of subsequent covered bonds.

It must be noted that the Amendment invalidates any action establishing a security interest for the liabilities of the mortgage bank over its receivables, the Other Funds, the Liquidity Reserve or the purchased financial hedging instruments that were recorded in the register of security interests for covered bonds unless the security interests were established for the purposes of financial hedging instruments or a payment system and securities settlement system of which the mortgage bank is a participant.

Credit refinancing through the issue of covered bonds

The Amendment also introduces significant changes regarding the refinancing of credit facilities and mortgage receivables through an issue of covered bonds. Here, the existing ratio of the maximum coverage of the financing of a credit facility/facilities/receivables through the issue of covered bonds (thresholds) has been changed. The maximum threshold of 60% of the amount of the mortgage lending value of property was extended to an individual credit facility/receivable. This means it will be possible to finance only a limited portion of such facilities/receivables (i.e. not more than 60%) through the issue of covered bonds – and the mortgage bank will have to find another method of financing the remaining part. Previously, this threshold applied only with respect to the entire portfolio, while the thresholds for individual credit facilities were not specified. At the same time, the threshold described above has also been raised to not more than 80% of the mortgage lending value of the property, with respect to the credit facilities/receivables backed with a mortgage established on residential properties, which is to constitute an incentive for banks to grant larger volumes of credit facilities of this kind (due to greater elasticity in financing through the issue of covered bonds).

The earlier requirement pursuant to which the amount of an individual credit facility secured with a mortgage could not exceed the mortgage lending value of the property was extended also to the purchase of receivables under such credit facility. This means that a mortgage bank will not be able to purchase the receivables of other banks under credit facilities secured with mortgages granted by them, if the purchase price of such receivables exceeds the mortgage lending value of the property. In such a case, the obligatory appraisal of such value against the purchase price of the receivables should be repeated, so that it can be verified whether the purchase of the receivables is not in conflict with the Act (following the changes introduced by the Amendment).

Setting out the information obligations in more detail

A greater emphasis has been placed on information for potential investors interested in purchasing covered bonds. The terms and conditions of issue of covered bonds issued based on the Act changed by the Amendment will be supplemented with information regarding:

- the manner and dates of payment of interest; and
- the dates and terms and conditions of redemption of the covered bonds in the event of the bankruptcy of the issuer mortgage bank.

The mortgage banks whose covered bonds issued before the Amendment are outstanding, will be subject to the obligation to publish the information set out above with respect to such instruments in *Monitor Sądowy i Gospodarczy*, within 6 months of the publication of the Amendment.

Changes with regard to the bankruptcy of mortgage banks

In the current legal regime, a major problem from the point of view of investors and rating agencies is the repayment of buyers of covered bonds of a bankrupt mortgage bank. A solution that secures the interests of the investors better involves clarifying the provisions relating to the separate estate arising by force of law, from which, in the case of the bankruptcy of a mortgage bank, the buyers of covered bonds will be able to satisfy themselves to the exclusion of the remaining creditors. Pursuant to the Amendment, a separate bankruptcy estate of a mortgage bank, free from any set-offs against the receivables of the creditors of the bankrupt mortgage bank, is to comprise the following elements:

- the receivables of the mortgage bank and the rights and funds, entered in the collateral register for covered bonds, invested in securities issued by central banks, funds deposited in the National Bank of Poland or held in cash, as well as the value of the over-collateralisation amount; and
- the funds obtained as a result of the repayment of receivables entered in the collateral register for covered bonds[1]; and
- the assets obtained in return for the assets entered in the collateral register for covered bonds.

Another change introduced to the bankruptcy law by the Amendment is the introduction of a "pass-through", i.e. the postponing of the maturity dates for the liabilities of a mortgage bank under the covered bonds. In the case of the announcement of the bankruptcy of a mortgage bank, they will be postponed to the latest maturity date for the receivables entered in the collateral register for covered bonds for a given issuer. In the case of the bankruptcy of a mortgage bank that is an issuer of covered bonds, the maturity of its liabilities towards the creditors under the covered bonds will be postponed by 12 months. By postponing the date of repayment, such a solution makes it possible to run a test verifying whether the rights and funds entered in the collateral register for the covered bonds are sufficient to fully satisfy the holders of the covered bonds, i.e. the so-called Coverage Balance Test (the "**CBT**"). If this test proves positive, a test is run verifying whether the above-mentioned rights and funds are sufficient to fully satisfy the holders of the covered bonds by the postponed maturity dates, i.e. the so-called Liquidity Test (the "**LT**"), whereby the due and payable but unpaid liabilities towards the creditors under the covered bonds are satisfied not earlier than after the first announcement of the results of the tests.

A bankruptcy trustee runs the CBT immediately, but not later than within three months from the date of announcement of the bankruptcy of a mortgage bank with respect to the separate bankruptcy estate (referred to above). The LT is run (within the same time limit) only if the result of the CBT was positive. Further tests are run in accordance with the following timetable:

- CBT – not less often than every six months;
- LT – not less often than every three months.

[1] The collateral register for covered bonds is a list of receivables, rights and funds that constitute the grounds for the issue of covered bonds, kept by a mortgage bank. Apart from the Other Funds, only the receivables secured by a mortgage entered into a land and mortgage register in the first place are subject to entry in the collateral register for covered bonds.

The consequences of running such tests are as follows:

<table>
<tr><th>Test result</th><th>Consequences</th></tr>
<tr><td>CBT +
LT +</td><td>

the claims of creditors under the covered bonds are satisfied in accordance with the terms and conditions of issue, and the maturity of the liabilities of the mortgage bank towards the creditors under the covered bonds will be postponed by 12 months;
the meeting of creditors in respect of the covered bonds convened on the basis of a request made not later than within one month from the date of announcement of the test results can, not later than within two months from such date, adopt (by way of a majority of two thirds of the votes of the creditors under the nominal value of the outstanding covered bonds) a resolution obliging the bankruptcy trustee to take actions in order to sell all of the receivables and rights of the bankrupt mortgage bank that constitute the separate bankruptcy estate;
the above-mentioned sale of receivables and rights can be made to:

a mortgage bank (with or without a transfer of the liabilities of the bankrupt bank towards the creditors under the covered bonds); or
another bank (without a transfer of the liabilities of the bankrupt bank towards the creditors under the covered bonds);

if the proceeds of the sale of the assets forming the separate bankruptcy estate decreased by the Liquidity Reserve and the due and payable but unpaid liabilities towards the creditors under the covered bonds amount to at least 5% of the total amount of the nominal values of the outstanding covered bonds, the claims of the creditors under the covered bonds can be satisfied pro rata to their amount, and these funds are transferred to the creditors under the covered bonds on the nearest date of payment of interest specified in the terms and conditions of issue, but not later than after 14 days from the date on which the decision of the judge-commissioner becomes final and unappealable;

</td></tr>
<tr><td>CBT +
LT -</td><td>

the postponing of the maturity date of the liabilities of a mortgage bank towards the creditors under the covered bonds (nominal value) by three years from the latest maturity date for the receivables entered in the collateral register for covered bonds; or
satisfaction of these claims pro rata to their amount on earlier dates, from the funds comprising the separate bankruptcy estate, provided that these funds, after their decrease by the amount of:

the total amount of the nominal value of interest on the outstanding covered bonds, to be paid within the next six months;
the costs of the bankruptcy proceedings in the scope of the separate bankruptcy estate, resulting from the bankruptcy trustee's report,

amount to at least 5% of the total amount of the nominal values of the outstanding covered bonds; and the satisfied part of the covered bonds is subject to redemption;
the meeting of creditors under the covered bonds can adopt, by a majority of two thirds of the votes of the creditors under the nominal value of the outstanding covered bonds, a resolution not to apply the above-mentioned rules or to apply another procedure;

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</table>

Test result	Consequences
CBT -	■ in the case of a positive result of the coverage balance test and negative result of the liquidity test, the rules on the postponement of the maturity date and pro rata satisfaction of claims apply accordingly; ■ a meeting of creditors under the covered bonds can adopt, by a majority of two thirds of the votes of the creditors under the nominal value of the outstanding covered bonds, a resolution to liquidate the separate bankruptcy estate and to sell the assets entered in the collateral register for covered bonds, whereby the liabilities of the mortgage bank towards the creditors under the covered bonds become due and payable upon the date of adoption of such resolution; ■ the above-mentioned sale of the assets entered in the collateral register for covered bonds can be made to: – a bank other than the mortgage bank without a transfer of the liabilities of the bankrupt bank to the creditors under the covered bonds to the buyer; or – an entity other than a bank, in the case of assets the possession of which is not reserved for banks; ■ the funds obtained from the sale of an asset entered in the collateral register for covered bonds without a transfer of the liabilities of the bankrupt bank towards the creditors under the covered bonds to the buyer are designated for the satisfaction of claims for the interest under the covered bonds secured by such asset only for the period until the date of the sale of such asset.

Tax advantages

The Amendment also introduces changes in the area of income tax (both PIT and CIT), the rates of which were indicated as one of the main impediments to the development of the covered bonds market, as banks were forced to charge withholding tax on transactions concluded with foreign buyers, which translated into a significantly lower attractiveness of such instruments, all the more that investors in the international market expected payment of a gross amount (gross-up). That barrier has now been abolished – all buyers, including both natural persons and legal persons will be released from the obligation to pay income tax on the interest and profit on the discount in respect of covered bonds as well as notes issued by Bank Gospodarstwa Krajowego or offered on international markets. Moreover, the exemption will also cover the income generated from the gratuitous disposal of such securities. Mortgage banks will be able recognise as tax-deductible costs any due and payable receivables classified as irrecoverable, as well as the provisions created to cover them. The latter will also apply to the buyers of such receivables that are not mortgage banks, but in their case, only 25% of such receivables will qualify as tax-deductible costs.

Facilitations for investing in covered bonds by Open Pension Funds (OFE) and cooperative savings and loan societies (SKOK)

The Amendment distinguishes covered bonds (as well as debt securities issued by credit institutions) as a separate category of investment assets of Open Pension Funds, and sets out separate investment limits in respect of such a category of assets. However, the total value of the assets of a given Open Pension Fund invested in covered bonds and notes of a single issuer may not exceed 5% of the total value of the assets invested by it. This will enable pension funds to become involved to a greater degree in the purchase of such instruments, which in turn creates a chance for increasing the liquidity of the covered bonds market.

At the same time, the legislator amended the Act on Cooperative Savings and Loan Societies and allowed them to invest their spare cash (not used for granting credit facilities or loans to the Society's members) in covered bonds. This is yet another attempt at maximising the liquidity of the market, in this case by way of allowing a new category of investors to actively trade on it.

Summary

The Amendment of the Act on Covered Bonds and Mortgage Banks gives investors a real chance to obtain long-term financing for mortgage loans. The situation has also been improved by a change of Recommendation F and Recommendation K issued by the Polish Financial Supervision Authority (KNF), both of which directly concern the determination by mortgage banks of the mortgage lending value of properties and the principles on which they maintain the collateral registers for covered bonds as well as the security account for such bonds. This will allow, through new issues, to significantly limit the liquidity risk of banks that grant such credit facilities. Thanks to the transfer of the portfolio of mortgage loans from a universal bank to a mortgage bank (i.e. a subsidiary company), and the issue of covered bonds by mortgage banks it will be easier to fulfil the capital requirements imposed by the new legislation of the European Union, and in particular the CRD IV/CRR legislative package[2].

Unfortunately, despite these changes a number of risks and issues remain to be solved. In this client briefing, we can only flag that some of those include:

- the costs and limitations related to the transfer of the portfolio of receivables under mortgages from a universal bank to a mortgage bank;
- loan limits related to "thin capitalisation", as set out in Art. 16 sec. 1 point 60 and 61 of the Act on Corporate Income Tax, in the context of providing guarantees for issues of covered bonds;
- potential taxation with VAT or with the tax on civil law transactions of the receivables due from universal banks to the mortgage bank;
- investment limits set for certain entities;
- doubts as to the possibility of conducting a public offering of covered bonds based on an information memorandum referred to in Art. 41 of the Act on Public Offering.

To sum up, the legal changes described in this briefing are an answer to the expectations of the financial market, both from the perspective of the issuers (mortgage banks) and the buyers of covered bonds, particularly foreign entities. Under the amended Act on Covered Bonds and Mortgage Banks investors have received a new investment instrument, much safer than other investment instruments, and banks obtain capital for the further development of lending and improvement of liquidity, while at the same time, the stability of the entire sector is strengthened. The fact that such changes were both necessary and were looked forward to is confirmed by the declarations of those operating on the Polish market for many years of their intention to open new mortgage banks. The existing players are already announcing new issues and are seeking future investors, also outside the borders of Poland.

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[2] Which comprises: Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (the Capital Requirements Directive IV, CRD IV) and Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (the Capital Requirements Regulation, CRR).

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