

”Wider usage of a covered bond as an instrument to stabilise the financing and funding of the mortgage market, particularly in times of liquidity crisis (an apex bank for funding through covered bonds)”

**Material discussed at the meeting of
the Mortgage Credit Foundation’s Committee for pooling mortgage receivables
on 24/04/2009**

INTRODUCTION

This analysis comes in particular as a response to the request made to the Foundation (in November 2008) by the Ministry of Finance to investigate the need for the implementation of covered bond pooling models in Poland. It is also part of various initiatives which the Foundation has undertaken since 1997 in favour of implementing and improving the effectiveness of covered bonds on the Polish market.

To begin with it is worth emphasising that from the regulatory point of view a covered bond has been “equipped” in a manner allowing its perception as a long-term credit funding instrument, which is fully compliant with European standards.

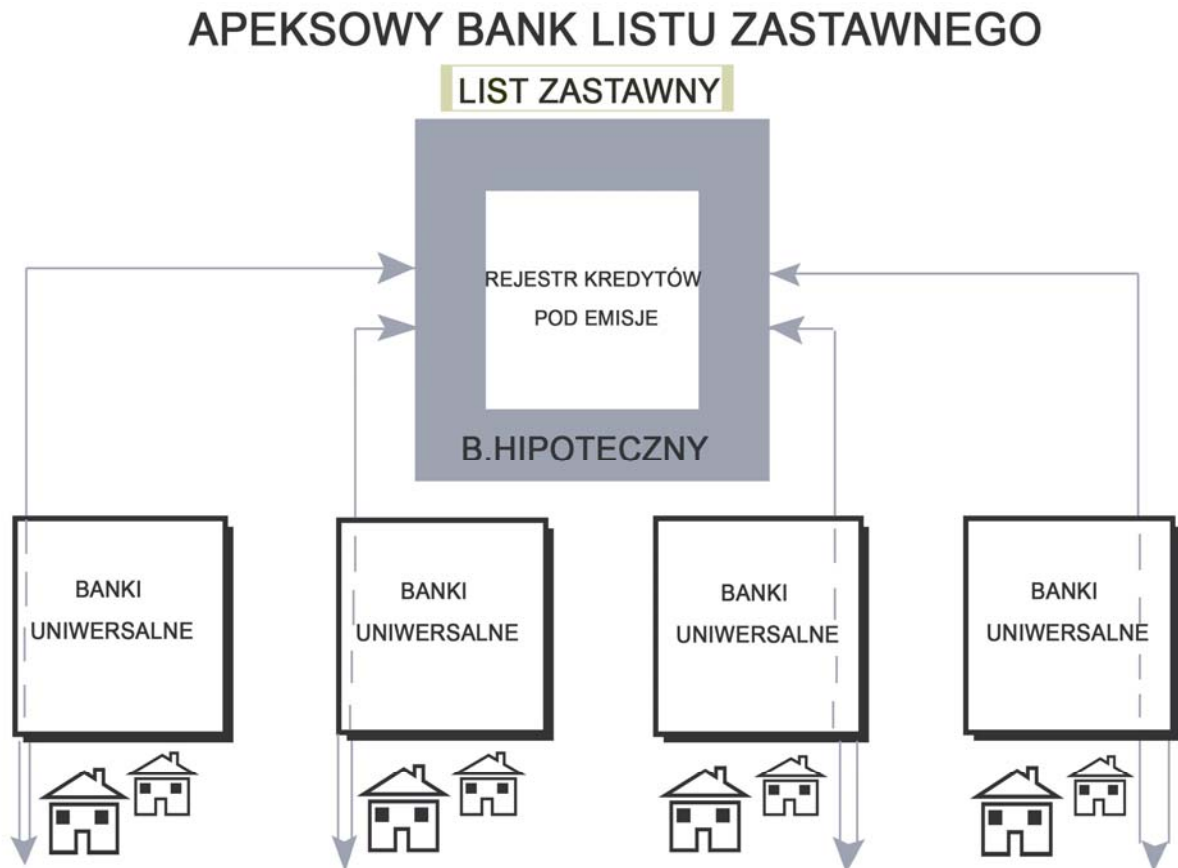
The Foundation’s activities have focused on namely:

- Preparing and implementing a range of **implementing and accompanying legislation**, including supervision regulations, regulations relating to property valuation, mortgage law, bankruptcy law, regulations relating to covered bond issues (prospectus; achieving the issue programme status), appropriately high limits for investment in covered bonds, etc.
- Providing training and publications enhancing the **know-how relating to mortgage lending value**, covered bonds, and their collateral.
- In 2008 the **Polish covered bond was notified** by the European Commission – KNF [Financial Supervision Authority] must give the covered bond a 10% risk weighting; due to the interpretation problems relating to the Capital Requirements Directive, the issue is pending.
- Also with respect to supervision regulations – interpretation was provided for European and domestic laws indicating the **grounds for applying a preferential risk weighting** for Polish covered bonds.
- Equally important was giving **pawn credit eligibility** and as of 31st March 2009 also **repo eligibility** to a covered bond. However, an agreement must be achieved with respect to the fulfilment of the procedure admitting an instrument for its participation in repo transactions – while the National Bank of Poland accepts for repo transactions securities registered with KDPW [National Depository of Securities], KDPW requires that the issuer provides interest tables 11 days before coupon maturity (rather than upon issuance or at the beginning of an interest-bearing period)! It would also be advisable to reduce the level of haircut in the case of covered bonds eligible for pawn credits – at the moment it is 25% where the level on other EU markets amounts to 12%.

Following 10 years' of presence of three mortgage banks on the Polish market, the Polish covered bond has consolidated its high reputation as being safe and, given the Polish conditions, most highly rated of the securities.

Therefore, it is the above-named aspects - namely the standard of regulations and the standard of issue quality - that provide the most significant potential of a Polish covered bond for further development.

I. CONCEPT OF AN APEX COVERED BOND BANK¹



The concept of "an apex covered bond bank" is based on the assumption that mortgage banks issue covered bonds against mortgage-secured credits acquired by universal banks.

Awaiting a decision and simulation in a business model: the method of transferring/ acquisition/ taking over mortgage receivables from universal banks by an apex covered bond bank.

¹ An apex bank – a financial institution acting as an intermediary, which grants loans or credits offered by other banks or funds established for handling a given type of credit financing. In the model discussed here, an apex bank acquires credits from other banks for joint covered bond issues.

II. WEAKNESSES OF A POLISH COVERED BOND

A barrier to using a Polish covered bond as a remedy, also to the liquidity crisis, is **the low market share of mortgage banks and the resultant low share of covered bonds in property financing in the Polish banking sector (ca. 3-4% of credit portfolio vs. ca. 20% in EU).**

Such low market share results from numerous factors including in particular:

- Mortgage banks operating in Poland belong to banking groups, where a universal bank offering the same mortgage products has a predominant position;
- Competition within banking groups, where a mortgage bank as a "single product" bank, with additional constraints resulting from the existing law, has a less favourable position;
- Continued trend of selling mortgage credits below cost and their high risk being accepted by universal banks (only mortgage banks are subject to conservative regulations);
- Continued trend of financing long-term assets with short-term deposits;
- Over-liquidity of the banking sector, which lasted until recently, and no need for diversifying sources of funding by universal banks.

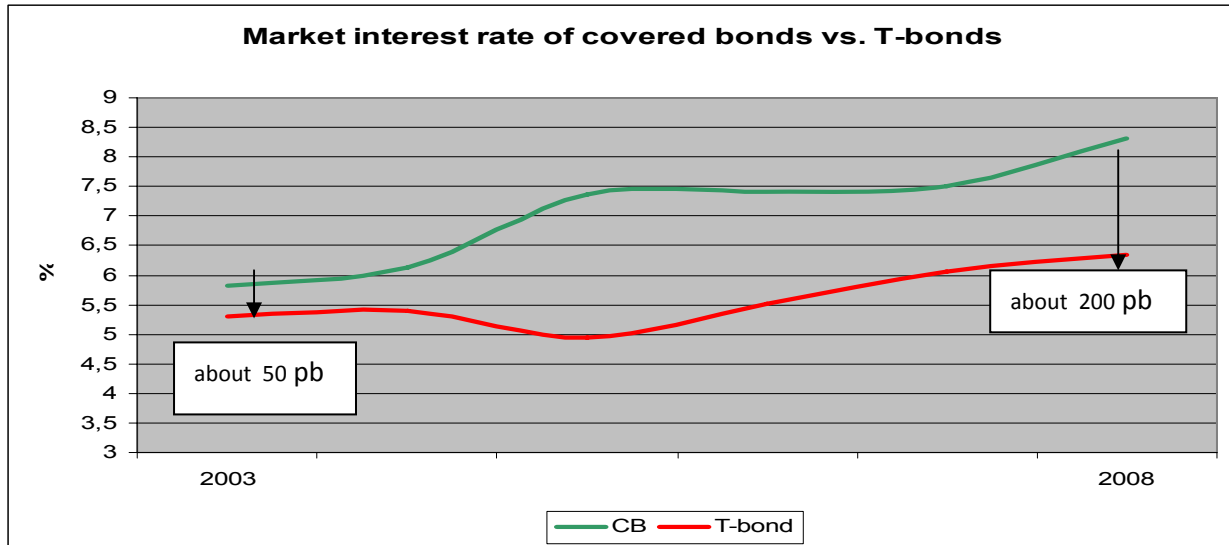
As a result of these factors **mortgage banks development did not reach their potential**. At the same time the absence of large and continuous issues along with the underdeveloped secondary market kept the cost of covered bonds at a relatively high level. Launching an apex business model for issuing covered bonds – which is optimal for the size of the Polish market – could also optimise their cost. Experience shows that in the case of the Polish market the quality of a covered bond (subject to very strict regulations) is not reflected in its price.

A key to improving the efficiency of the system of covered bonds is the implementation of a business model, which will secure stable, inexpensive, long-term funds for property financing. The apex model provides access to funding based on covered bonds also to universal banks without such banks having to incur costs connected with getting directly involved in organising issues within their internal structures.

III. GOAL – OPTIMISING THE COST OF A COVERED BOND

The point of reference is the interest on treasury securities on a given market.

As a rule – in EU – it is a few to a dozen or so base points above the interest on treasury bonds. However, in the case of a Polish covered bond this difference amounted to over 200 base points. This is shown on the chart below – it is worth noting that as of 2003 this unjustified price disproportion (interest rates on securities)



curities) has been deepening.

Source: Polish Mortgage Foundation

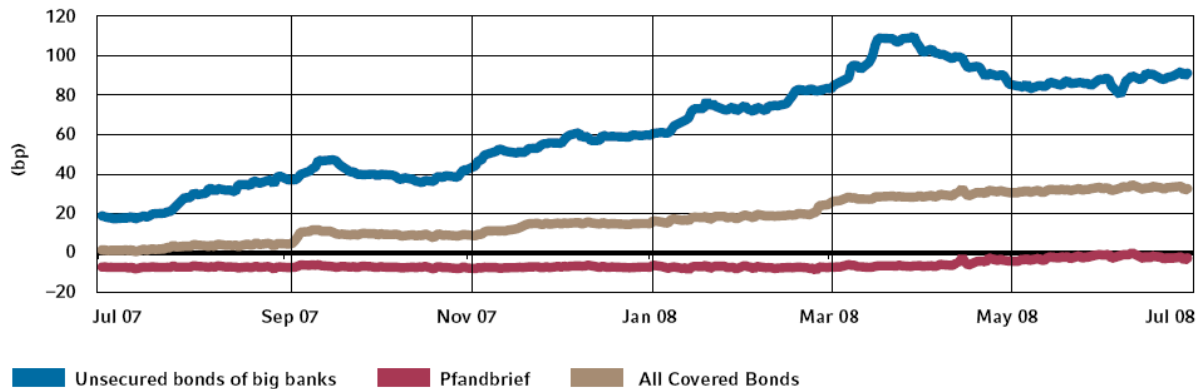
Interest rates on coupons for covered bonds issued by banks in Poland up to August 2007 (ie. before the emergence of the subprime crisis in USA) were continuously decreasing (from 0.60% - 0.75% above LIBOR / EURIBOR for the first non-public issues of covered bonds in USD or EUR with maturity from 5 to 7 years to ca. 0.25% above LIBOR / EURIBOR for the last non-public issues of 5-year covered bonds prior to the crisis). As of September 2007 they have been quickly increasing. A similar situation was observed for public issues and mortgage covered bonds in the public offering.

The fact that the cost of a Polish covered bond is too high is also confirmed by a comparison to uncollateralised bank bonds. The difference appropriate for this instrument would be ca. 30 base points (up to 60 base points in the time of crisis) – the chart below shows the typical situation on the EU markets.

It is worth emphasising that for further development of the covered bond market it would be advisable to issue covered bonds based on a fixed interest rate – rather than on WIBOR, as it is a money market rate – and short term by its nature. If we do not link the price of covered bonds to WIBOR (as it is now) but instead - to government securities, the spread between covered bonds and treasury securities will decrease. To date interest rates on treasury securities have been changing more dynamically than interest rates on covered bonds, which supported the maintenance of a wide spread, thus relatively increasing the cost of covered bonds. The development of covered bonds based on a fixed interest rate (hence also – fixed rate credits) – could clearly contribute to the stabilisation of the mortgage credit funding market in Poland. Their launch on the Polish market would be linked with extending the credit offer with fixed rate products – as under current market conditions the funding of variable rate credits with a fixed rate covered bond would not be cost-effective. However, it is worth remembering that the existing situation – ie. a period of relatively low

interest rates – is a good moment for the development of fixed rate mortgage credits. Also institutional investors show high interest in Polish covered bonds based on a fixed interest rate.

SPREAD DEVELOPMENT VS. SWAPS



Source: IBOXX

In Poland the interest rate on covered bonds is usually similar to the interest on uncollateralised bank bonds for the same period, which once again indicates that the quality of covered bonds is not reflected. It is worth emphasising that while a covered bond may have a higher rating than its issuer (even by 2 levels), it is not possible for a bank bond.

A consequence of forcing up the cost of a covered bond is its perception as **a relatively expensive method of credit funding** – paradoxically, even in times of a liquidity crisis a Polish covered bond is not perceived as “profitable” (here, we ignore the fact that there are no system incentives to consistently promote the rule that long-term credits should be funded by long-term liabilities).

The **REASON** behind the high price of Polish covered bonds is that their issues do not reach the parameters, which are necessary to accept a lower price (eg. + 50 base points above state treasury bonds) from the investor’s perspective.

As international experience shows such parameters allowing for an optimised price of a covered bond are:

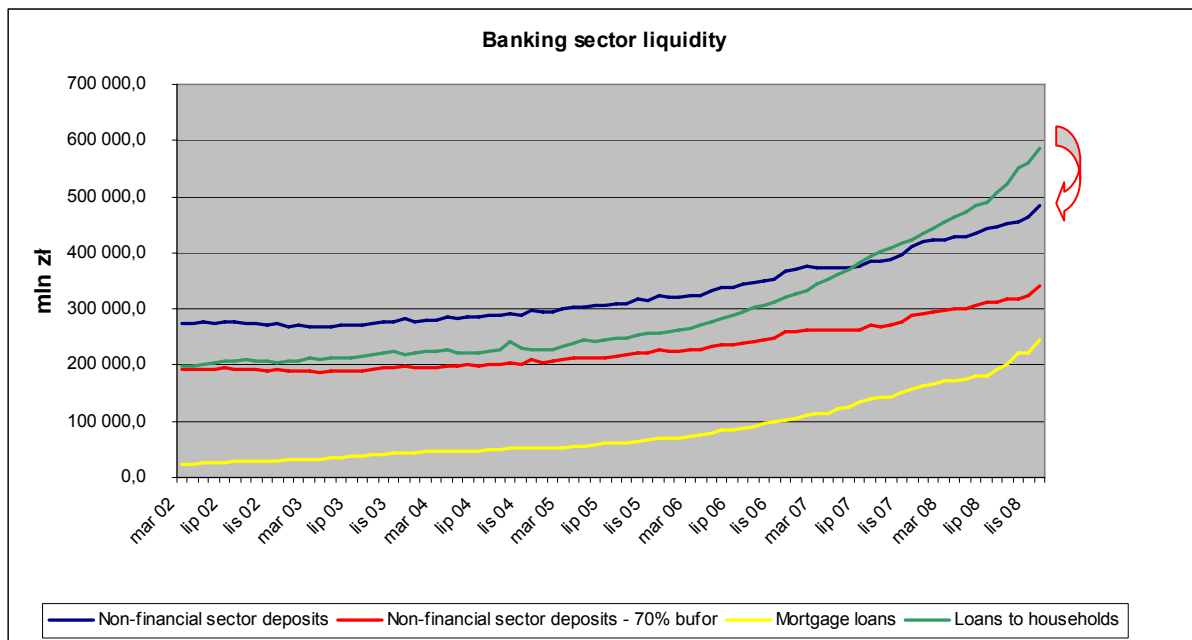
- **Issue volume** - only a certain issue volume enables the reaching of an effective ratio between fixed costs relating to the issue and its value (minimum 200,000 €)
- **Liquidity, issue continuity** – this parameter is particularly valued by investors in times of liquidity crisis – liquidity consists of the regularity of market launches of new issues (the need for on-going reference to issue value and the so-called “taking care” of the instrument in the system).

IV. POLISH PROBLEM RELATING TO ISSUE LEVEL – single banks will not increase the level

To date Polish issues of covered bonds took place 1-2 times a year and the value of an issue did not exceed PLN 250 million; while the value of the Polish mortgage covered bond market is ca. PLN 2,338 million, in 2008 the total issue value amounted to PLN 820 million.

In order to improve the dynamics of the Polish covered bond market the system must secure an on-going and current inflow of mortgage credits, which can be used as the base for an issue. **No single bank in Poland is able to do this on its own.** The situation is that the largest banks – producers of a new mortgage portfolio – also happen to have quite good access to the deposit base – hence, they are not strongly interested in covered bond issues. At the same time medium-sized banks, not mentioning small banks, are doomed to even higher costs of covered bonds than the current issues (for example, due to the cost of implementing additional solutions which would enable a universal bank separate the risk of a covered bond from the risk of other activities). This means that even the liberalisation of the law – ie. granting all banks the right to issue covered bonds – will not generate too many new covered bonds on the Polish market. Moreover, the liberalisation of the law will not favourably impact the security of bank deposits or the standardisation of bank products and processes, thus also the transparency of covered bonds issued. This in turn will have a clearly negative impact on the cost of a covered bond.

At the sector level there is a demand for covered bonds, but the appropriate volume of new issues can only be achieved by pooling². The chart below shows that whereas some market participants still have deposits allowing for dynamic credit action, at the sector level there is a clear need for an alternative source of capital.



Source: Mortgage Credit Foundation based on NBP data.

If so, what can be done to increase the frequency and liquidity of covered bond issues in Poland? – ensuring an on-going inflow, in the system, of mortgage receivables from different sources as the base for issues.

² Pooling – using mortgage credits granted by universal banks as the base for covered bond issues

On the relatively small Polish market this can be achieved by creating a system of 2-3 independent issuer-mortgage banks (the apex model; stock exchange banks)

On one hand this system would ensure:

- Specialisation in the area of mortgage credits, thus also the standardisation of products and processes
- Better control by the supervision authority
- Improved security and transparency of covered bonds issued
- Lower cost of funding obtained via covered bonds

On the other hand, in universal banks the system would ensure:

- Improved security of deposits (no long-term assets sensitive to cycles)
- Possibility to more effectively manage the structure of assets and liabilities (long-term mortgage credits could be replaced with covered bonds issued by independent issuer-banks, which on the developed secondary market would provide greater liquidity opportunities)
- In time of crisis, better access to assistance (eg. selling covered bonds)
- Similar incomes (interest income from credit replaced with interest income from a covered bond or bonds + commission for client acquisition)
- Lower capital burden due to the difference in risk weightings for credits and covered bonds

In today's conditions the function of an apex bank should be performed by a bank under special supervision by KNF [Financial Supervision Authority] (as required for "a covered bond" in the directive).

The above idea is also supported by the analyses which the Foundation carried out in relation to the success of covered bonds in foreign markets, particularly the analyses of Hungarian and Latvian markets and EU markets which are similar in size or potential.

Given the Polish legal situation the apex function could also be performed by specialist mortgage banks, which operate under the Law of 1997 (same as in the Hungarian, Danish, and German models) or by an institution, established for this particular purpose, operating under separate regulations - a bank or a funding centre (the Swiss, Austrian, French models). It is advisable that such a funding centre is supported by state capital or receives some other form of support, which would help effectively influence the prices (interest rates) of covered bonds. It is worth noting that as regards assistance packages in order to "liven up" the capital market EU governments and central banks are currently providing several billion worth of support for covered bonds.

Legislative decisions should be made on the following aspects of the apex model:

- a. How to ensure the sovereignty and market neutrality of an issuer-mortgage bank?
- b. Should it be a stock exchange bank or should other forms of equity injections be considered?
- c. Calculating demand
- d. Confirming profitability
- e. Deciding whether credits should be subject to secondary (purchasing) or primary (granting) pooling

The pooling system could be complementarily organised and based on the regulations which already exist in Poland. Whereas the Law on covered bonds and mortgage banks amended in 2000 contains the germ of the idea of funding other bank's receivables, its complete implementation requires the legal infrastructure, which would enable the application of an appropriate business model, relating to accounting, rules concerning balance sheets, calculating capital ratios, as well as necessary changes in mortgage legislation.

It is most important to gain understanding of the economic meaning of pooling models for mortgage funding among Polish market experts, legislators, and bankers and to develop appropriate legislation following the selection of the business model – based on the analyses carried out in 2005 the Polish Mortgage Foundation could quickly formulate relevant legislative suggestions.

Guidelines for the economic model of the functioning of mortgage apex bank in Poland – for discussion and verification

Assumption	Calculation
The model relates only to residential mortgage loans denominated in Polish zlotys. The average annual growth of growth is assumed on the level of 30 billion zlotys – 20% of which (6 bln PLN) will be in 80% funded via covered bonds (<i>list zastawny</i>).	Portfolio amounting to 6 000 mln zlotys, will create an asset pool of 4 500 mln zlotys.
<p>Average margin of mortgage loans over WIBOR – 2,5%</p> <p>Average margin of covered bonds over WIBOR – 1,0%</p> <p>Average margin of banking bonds over WIBOR – 2,0%</p> <p>Administrative costs – 0,5% (based on data from the Swiss apex system)</p> <p>Cost of reserves – 0,4 %</p>	<p>Profit:</p> $6000 * 2,5\% - 4500 * 1\% - 1500 * 2\% - 6000 * 0,5\% - 6000 * 0,4\%$ <p>= 21 (million zlotys)</p> <p>The income from the credit portfolio is reduced by:</p> <ul style="list-style-type: none"> ➤ Cost of funding the part of portfolio via covered bonds ➤ Cost of funding the part of portfolio via banking bonds ➤ Administrative costs (mainly staff verifying the quality of collateral) ➤ Cost of reserves
<p>Capital requirements for credit risk, assuming solvency ratio of 10% (according to the last recommendation of the Polish Financial Supervision Authority); the CRD requires 8%.</p> <p>Risk weight of 35% (exposures fully and completely secured by mortgages on residential property) - according to z § 62.1 of the Polish Financial Supervision Authority's Resolution No. 380 / 2008</p>	$6000 * 0,35 * 0,6 * 0,10 + 6000 * 0,75 * 0,4 * 0,1 = 306 \text{ (million zlotys)}$
ROE gross	$21/306 * 100\% = \mathbf{7\%}$

Commentary:

For servicing part of the mortgage credit market (20% of the new portfolio production must satisfy the requirements relating to a covered bond issue), an apex bank must have equity at the level of PLN 366 million (capital requirement due to credit risk; for comparison – in 2008 the corresponding requirement for BRE Bank Hipoteczny was ca. PLN 308 million). In subsequent years the bank should receive additional capital depending on funding needs. Several models could be considered here – either a stock exchange bank or additional capital injection by the bank’s owner or by the banks using the model, parity based, by portfolio transfer.

Under existing circumstances the bank is profitable because the minimum ROE = 7% is satisfactory given the assumed economic function. However, worth considering are various methods of system support which are used for instruments like a covered bond in most EU member states. The available support instruments include:

- liquidity instruments – eg. liquidity guarantees, intervention purchases made by designated domestic investors, increasing repo opportunities, etc.
- fiscal instruments – eg. exemptions for covered bond interest from income tax – if the regulator decides that the model is worth promoting, because it protects the deposit system from risk (separating long-term mortgage-based assets).

In either case an apex model for covered bonds ensures the possibility of effective (because it focuses on one or two entities) interventions and policy stabilising the financial system – also in the event of economic crisis.

VI. BENEFITS of apex funding through covered bonds for the Polish market:

- All banks can participate – also medium-sized and small
- Achieving the required level and frequency of covered bond issues
- Independence of funding sources from foreign capital (internal money circulation on the market)
- Reduced cost of funding – a low ratio between fixed costs and value of a given issue:

Fixed costs, including:

- rating
- monitoring and supervision – trustee etc.
- market and system marketing
- register and account maintenance – specialist personnel and IT costs
- prospectus (legal services and fees)
- market placement
- system support intervention as now – in times of crisis – such assistance is currently provided in EU markets

The APEX FUNDING MODEL through covered bonds also helps **avoid the following costs** (which are incurred for issues performed directly by universal banks):

- Banking supervision costs (additional specialist personnel for supervising covered bonds) transferred to banks
- BFG [Bank Guarantee Fund] costs shifted to banks – an increase in the BFG contribution is expected in connection with the enforcement privilege for covered bond buyers – versus other creditors (including deposit holders) – in relation to the assets of a bank which has lost liquidity.
- Clear separation in the system of the risk relating to bonds based on mortgage assets, public in character from the risk/ protection of deposit holders (a covered bond – still outside the deposit system).

In the case of a positive decision by market participants, regulators, the Mortgage Credit Foundation is ready to carry out a workshop/ analyses addressing the following aspects of pooling models:

- questions relating to balance sheets and accounting
- alternative methods of calculating capital ratios in a universal bank and an apex bank
- the problem and price of over-collateralisation
- the cost and methodology of validating the quality of assets transferred as the base for a covered bond issue
- solving the issue of outsourcing
- approach to property valuation
- transferring mortgage liabilities and legal equivalent methods vs. maintaining a covered bond standard

VII. NECESSARY LEGISLATIVE CHANGES

A need to amend the Banking Law (Art. 6a) with respect to outsourcing – allowing mortgage banks to service credits granted by universal banks

Pursuant to Art. 15 paragraph 1 point 8 of the Act on Covered Bonds and Mortgage Banks a mortgage bank can manage the receivables of other banks (mortgage and universal) arising from credits which are collateralised by mortgage. However, this right is in conflict with the provisions of the Banking Law relating to outsourcing. In 2004 the legislator introduced the possibility for a bank to entrust an operator with agency services relating to bank activities, ie. outsourcing. At the same time Art. 6a paragraph 2 of the Banking Law bans the outsourcing of bank management, in particular the management of risk arising in connection with running bank activities, including the management of assets and liabilities, the assessment of credit worthiness, and the analysis of credit risk. As a result a mortgage bank could manage the receivables of other banks (because such possibility is provided in the Act on Covered Bonds and Mortgage Banks), but such activities (servicing credits granted by universal banks) cannot be outsourced by universal banks due to the explicit ban under Art. 6a paragraph 2 point 1 of the Banking Law. Hence, this provision needs to be changed – exempting

mortgage banks from the ban referred to in Art. 6a paragraph 2 point 1 of the Banking Law relating to the outsourcing of bank management activities, including the management of assets and liabilities.

Suggested change:

Art. 6a paragraph 2 of the Banking Law shall receive the following wording:

2. The outsourcing of the activities referred to in paragraph may not include:

1) bank management in the understanding of Art. 368 § 1 of the Law of 15th September 2000 - Commercial Companies Code (Journal of Laws No. 94, item 1037; of 2001 No. 102, item 1117, and of 2003 No. 49 ,item 408 and No. 229, item 2276), hereinafter referred to as the "Commercial Companies Code", and in the understanding of Art. 48 of the Law of 16th September 1982 – Co-operative Law (Journal of Laws of 2003 No. 188, item 1848), hereinafter referred to as "The Act – Co-operative Law ", in particular the management of risk arising in connection with running bank activities, including the management of assets and liabilities, the assessment of credit worthiness, and the analysis of credit risk;

1a) The ban referred to in point 1 shall not apply to managing by a mortgage bank of receivables of a mortgage bank or other banks arising from credits as well as granting credits on behalf of other banks on the basis of relevant co-operation agreements as referred to in Art. 15 paragraph 1 point 8 of the Act on Covered Bonds and Mortgage Banks.

2) conducting an internal audit of a bank.

VIII. FINAL DIAGNOSIS OF THE POTENTIAL OF A COVERED BOND WITH AN APEX SYSTEM ON THE POLISH MARKET

For universal banks:

- Being able to fund part of the bank's portfolio without incurring the costs of a covered bond issue (a need to analyse costs and risks of the apex model vs. an independent covered bond issue by a universal bank)

There are some markets where both systems ie. the apex model and the possibility of independent covered bond issues by universal banks are allowed – however, it must be economically determined to what extent the two system are complementary.

- Eliminating certain burden for the bank's balance sheet and capital requirements due to long-term mortgage assets
- Leaving a universal bank in the position of a party offering (and servicing) mortgage credits – hence, being able to cross-sell other bank products while offering a mortgage credit
- Being able to partly replace the assets with 35-100% risk weighting with a covered bond (10% risk weighting)

For mortgage banks:

- Being able to transform into apex issuer-mortgage banks. If the calculation in the model relating to equity is correct, even mortgage banks operating today could provide apex services to a significant part of the market. However, a problem of the bank's neutrality toward other apex participants must be resolved (state capital contribution or appropriate dispersion of shareholders – shares in the equity of an apex bank).
- Providing apex mortgage bank's services only within a concern, thus giving the funding instrument a new price dimension
- A covered bond gaining a wide market share, increasing its liquidity, issue volume, price effectiveness.
- Increasing the profitability of a mortgage bank by reducing the cost of obtaining funds from the capital market and improving the ratio between the fixed costs of an issue (prospectus, ratings) and its value.

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Polish Mortgage Foundation