



Polish Listy Zastawne Legal issues regarding insolvency regime

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Strategic Group for Mortgage Banks and Listy Zastawne
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Outcome of the meetings in Frankfurt, Barcelona and Warsaw,
September/ October, 2013

Solutions agreed between relevant issuers, banking groups, investors,
„system auditors”

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Executive Summary



1. The insolvency protection of Polish L.Z. is to some extent a grey zone. Many questions, which are asked by investors, analysts and rating agencies cannot be clearly answered on a sufficient level. Therefore improvements to the legal regulations are expected.
2. Both timely payment and over-indebtedness issues must be taken into account, when looking for solutions.
3. Any over-indebtedness of the cover pool would mean that – according to the actual legislation – the risk of losses on cover assets would be concentrated on L.Z. with the longest maturities (time subordination).
4. Timely payment of hard-bullet L.Z. after a mortgage bank insolvency cannot be guaranteed due to liquidity mismatch.
5. Therefore, the Strategic Group for Mortgage Banks and Listy Zastawne (the Mortgage Credit Foundation, the Polish Mortgage Banks and their mother banks) recommends to make insolvency proceedings rules concerning mortgage banks after declaring bankruptcy more precise and flexible. In particular it is recommended:
 - to regulate a minimum statutory OC of 10 % that would include a liquidity buffer (see additional graphs),
 - to regulate that any cash flow on cover assets belongs automatically to the cover pool after a mortgage bank insolvency,
 - to create a statutory soft-bullet-structure in case of a mortgage bank insolvency,

1. Call for changes to the Law

1. For Polish and especially for international investors, to invest in L.Z. makes much more sense, if its rating is much better than the one of its issuer and its mother bank (lower risk).
2. For Polish banking groups, refinancing with L.Z. is reasonable particularly when spreads are lower than in their senior debt programs (lower interest burden).
3. Rating agencies, investors and analysts ask more and more detailed questions regarding insolvency protection of covered bonds as in particular:
 - a) timely payment of L.Z. after their issuer goes insolvent cannot be guaranteed as:
 - long-term cover assets mismatch with shorter maturities of L.Z.,
 - an insolvency estate has no refinancing possibilities (incl. central bank liquidity),
 - it would not be easy to get (or even collateralise) liquidity loans from other banks,
 - fire sales of cover assets should be, in rating agencies opinion, prevented,
 - only other mortgage bank could take over all the cover assets and L.Z. of an insolvent mortgage bank,
 - b) time subordination is possible based on reference of the Mortgage Banks and Cover Bonds Act to the Bonds Act (the acceleration of L.Z. in case of mortgage bank's insolvency is excluded by law, however, under the Bonds Act to which the Mortgage Banks and Cover Bonds Act refers, the bondholder may request immediate redemption before insolvency procedure is implemented),
 - c) no statutory remedies for overindebtedness (if it occurs) are in place.
4. Rating agencies assume it is very unlikely that a timely payment of L.Z. could be ensured, if a Polish mortgage bank goes insolvent. (FitchRatings, 12.2.2013: „The D-Cap of 0 is driven by the full discontinuity risk assessment of the liquidity gap ...“).
5. Therefore the rating of L.Z. is still very closely linked to the rating of the mortgage bank – and thus closely to the rating of the mother bank. From the rating perspectives, the LZ cannot be rated at the highest level possible for the covered bond instrument.
6. There are no clear regulations in the existing mortgage bank law, what to do in case of over-indebtedness or a liquidity mismatch.
7. Bank resolution directive, bail-in and asset encumbrance issues are also driving such discussions.

2. Recommendation 1 liquidity buffer



Recommendation 1: Regulate a minimum statutory OC of 10 % that would include the liquidity buffer

A statutory overcollateralization (OC) of 10% should be introduced in the Mortgage Banks and Cover Bonds Act that would:

1. apply to all kind of covered bonds (L.Z),
2. be calculated on nominal basis regarding the capital amount of outstanding L.Z.,
3. 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 a liquidity buffer constituting part of the OC (valuation – nominal value);
4. Individual terms and conditions of each program would define:
 - a) type of liquid assets held within OC
 - b) the percentage of liquid assets in the cover pool - it is assumed that value of the liquid assets would ensure full and timely payment of the interest on the outstanding amount during the next 12 months. The liquid assets would be measured at their market value.

4. Recommendation 2 commingling and set-off risk (remedy)



Recommendation 2: Regulate that any cash flow on cover assets belongs automatically to a cover pool after insolvency of a mortgage bank

Commingling and set off risks could be reduced a lot following the new Belgium CB law: Create a regulation that cash flows on cover assets belong automatically to a cover pool – and not to an insolvency estate.

2. Recommendation 3 soft-bullet structure (1/2)



Recommendation 3:

It should be regulated that since the opening of the insolvency procedure of a mortgage bank the following process will be followed:

1. 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. (as per interest rate and frequency of payments) in case of the issuer's insolvency from the mandatory liquidity buffer (part of OC).
2. As a next step, 2 tests shall be performed by the insolvency administrator, checked by the kurator and validated by respective authority: the over-indebtedness and liquidity tests which results will determine the next steps. Results of these tests shall be validated by the auditor. In particular:
 - a) tests' formulas will be defined in the statutory law,
 - 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 (validated by the kurator and, quarterly, by the respective authority);
 - over-indebtedness test – semi-annually (validated by the respective authority).

3. Recommendation 3 soft-bullet structure (2/2)

4. Based on the two tests results, the following „bottom line” procedure is commenced automatically (by statutory law):
 - a) if the over-indebtedness test is failed – all L.Z. are accelerated („acceleration”) but rights of all L.Z. holders become equal, division of proceeds on a pari-passu basis (no time-subordination),
 - b) if the over-indebtedness test is passed, then:
 - if the liquidity test is passed – 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);
 - interest rates and frequency of payments are subject to L.Z. terms and conditions;
5. The „bottom line” 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:
 - how to liquidate the cover assets in case of acceleration;
 - implementation of acceleration procedure in case only the liquidity test is failed (instead of extension).

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 not also provide for acceleration option.