Mortgage Banks

Throughout the world, banks extend credits for buying or building houses or for buying real estate. Due to the high level of collateral the credits are very secure. However, not all countries have created special legislation that makes it easier for banks to refinance these credits by issuing legally defined mortgage bonds or "covered bonds", as they are mainly referred to in the international capital markets.

In Denmark and Germany the legal foundations for mortgage bonds were established more than 100 years ago. This long tradition, coupled with accumulated market experience, is the likely reason why these countries today account for the bulk of mortgage refinancing – outstanding and new issuance – in Europe (see Figure 1). The total market volume in Europe in terms of stocks of issued covered bonds amounts to about € 1.5 trillion.

Also in France legal provisions for mortgage bonds date back to the 19th century – but a sizable market for such bonds never developed due to legal inadequacies. It was only in 1999 that a new law was introduced in France.

In the United Kingdom and in the United States (as well as in Iceland) there is no specific law that regulates mortgage bonds. UK banks have a long tradition in refinancing their real estate and housing loans via so-called Asset Backed Securities (ABS). A major difference to covered bonds is that ABS are bonds issued by a special purpose vehicle on which all the underlying assets are transferred, while covered bonds have an on balance sheet character, implying that all cover assets remain on the balance sheet of the issuer at least until an issuer goes insolvent. In order to diversify their investor base and to create a more liquid refinance instrument some British banks have recently started to create *Pfandbrief*-like bonds on a contractual basis, so-called structured covered bonds.

In the United States three-fifth of the mortgages extended for single-family homes are financed through the issuance of Mortgage Backed Securities (MBS), sub-markets of which are guaranteed by the Government National Mortgage Association (Ginnie Mae).

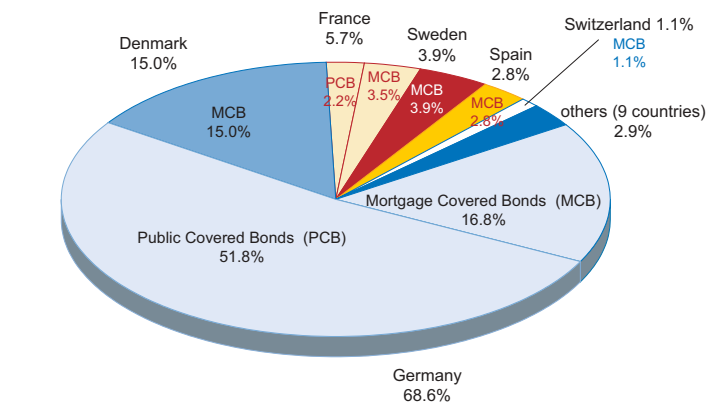
In several countries covered bonds are not only covered by real estate collateral but also by public sector credits (at the state, regional and communal level). These bonds are called "public covered bonds". However, it is only in Germany that these bonds represent a larger share of outstanding covered bonds than the mortgage bonds proper (Figure 1).

With five notable exceptions all EU member countries dispose of a specific "covered bond" law. The exceptions concern – beside the UK – the Netherlands, Belgium and Italy. Also Estonia has not introduced a mortgage law up to now. While in Italy, Belgium and Estonia a covered bond legislation is under preparation, it is up to now only considered in the Netherlands. EU candidate countries like Bulgaria and Romania have already introduced such a law, while it is prepared in Croatia. Russia has recently introduced a legislation, while it is under consideration in the Ukraine. Figure 2 gives an overview on the year of introduction of legislation in Europe.

Figure 1

Market Share of the European Covered Bond Countries in the European Covered Bond Market

outstanding bonds, September 2004



Source: Association of German Mortgage Banks.

Covered bond regulations differ between countries in several respects. Tables 1 and 2 contain the respective information. Some regulatory features of special interest are summarised below.

1. The valuation of a mortgage loan eligible as a covered bond may rest on either the mortgage lending value or the market value of the collateral. The central European countries and

Table 1

Covered bond legislation in Europe: Basic system characteristics

	Regulation entered into force	Special-ist bank principle	Refinance-able through covered bonds	Cover register	Legally anchored preferen-tial right in bank-ruptcy	Regula-tions on valua-tion	Relative lending limit for funding through covered mortgage bonds	Absolute lending limit for funding through cov-ered mortgage bonds
Denmark	1850/1989	Yes	Mortgage loans	No	Yes	Yes	40/60/70/80/ 84% of value of collateral	Yes
Germany	01.10.1900	Yes	Mortgage and public sector loans	Yes	Yes	Yes	60% of value of collateral	Basically no (100% of market value)
Greece	1924	Yes	Mortgage loans	Yes	Yes (but uncertain)	Yes	75% of mar-ket value	75% of mar-ket value
Austria	01.01.1939	Yes	Mortgage and public sector loans	Yes	Yes	Yes	60% of value of collateral	No
Switzer-land	01.02.1939	Yes	Mortgage loans	Yes	Yes	Yes	2/3 of value of collateral	No
Spain	05.05.1981	No	Mortgage and public sector loans	No	Yes	Yes	70/80% of market value	No
Portugal	16.04.1990	No	Mortgage loans	Yes	Yes	Yes	80% of mar-ket value	No
Sweden	1992	In praxi: yes	Mortgage loans	No	No	Yes	60/75/85% of value of the property	No
Czech Republic	01.07.1995	Limited mort-gage bonds licences	Mortgage loans	"inde-pendent decla-ration"	Yes	No	70% of mar-ket value	No
Slovak Republic	01.03.1996	Limited mort-gage bonds licences	Mortgage loans and government loans secured by mortgages	Yes	Yes	Yes	70% of value of collateral	No
Hungary	07.06.1997	Yes	Mortgage loans	Yes	Yes	Yes	60% of value of collateral	70% of mort-gage lending value
Luxem-bourg	19.12.1997	Yes	Mortgage and public sector loans	Yes	Yes	Yes	60% of value of collateral	Basically no
Poland	01.01.1998	Yes	Mortgage and public sector loans	Yes	Yes	Yes	60% of value of collateral	100% of mortgage lending value
Latvia	29.09.1998	No	Mortgage loans, loans guaranteed by government or munici-palities	Yes	Yes	Yes	60/75% of market value	No
France	27.07.1999	Yes, but no per-sonal	Mortgage loans, public sector loans and loans guaranteed by banks or insurances	No	Yes	Yes	60/80/100% of value of collateral/ market value	60 / 80 / 100% of mortgage lending value/ market value
Romania	09.12.1999	Unclear	Mortgage loans	No	No	No	60% of value of portfolio	No

(Table 1 continued)

	Regulation entered into force	Specialist bank principle	Refinanceable through covered bonds	Cover register	Legally anchored preferential right in bankruptcy	Regulations on valuation	Relative lending limit for funding through covered mortgage bonds	Absolute lending limit for funding through covered mortgage bonds
Finland	01.01.2000	Yes	Mortgage and public sector loans	Yes	Yes	Yes	60% of value of collateral	Basically no
Bulgaria	13.10.2000	No	Mortgage loans	Yes	Yes	Yes	60/80% of market value	No
Ireland	22.03.2002	Yes	Mortgage and public sector loans	Yes	Yes	Yes	60/75% of the prudent market value	yes (80% of prudent market value)
Lithuania	10/2003	No	Mortgage loans	No	Yes	Yes	30/40/50/70 % of mortgage value (prudent market value)	No
Russia	18.11.2003	No	Mortgage loans	Yes	Yes	No	70% of market value	No
Norway	Forthcoming 2004	Yes ("kreditt-foretak")	Mortgage and public sector loans	Yes	Yes	Yes, regulation by the supervision	60% of market value	60% of market value
United Kingdom	No specific legal provision for covered bonds.							
United States	No specific legal provision for covered bonds.							

Sources: Association of German Mortgage Banks (2004); Hagen, L. (2004).

Finland have chosen the first way, while Sweden, the Baltic countries, Portugal and Spain have taken the second route.

2. For being eligible loans funded by covered bonds must not exceed a certain percentage of its underlying value. This ratio is 60 percent in several countries, while it is 70 percent in some other. In some countries a range of ratios might be applied.

3. An important question is also who is allowed to issue mortgage bonds. In central Europe the specialist bank principle holds, while it is not – or less strictly – applied in the countries of South-Eastern and South-Western Europe.

4. The specialist bank principle is very strictly applied in France, Finland and Ireland, where the covered bond issuer is allowed only to hold eligible assets. In Denmark, Germany, Hungary, Luxembourg and Poland the specialist bank principle holds but the banks are allowed also to keep non-eligible assets (which, by definition, do not contribute to the "cover"). The mortgage market in Russia and Latvia is characterised by the universal bank principle. There, any bank, provided that it has got a qualified covered bond licence, may issue mortgage bonds. In Germany there is a new legislation under way which will also introduce the universal bank principle (with qualified licensing).

5. To deserve the name "covered bond" the bond in question must possess special security properties. The most important properties are that their underlying assets must be "segregated" (i.e. not mixed up with those of less secure bonds) and "remote to bankruptcy" in case of an issuer's insolvency. In most countries (but not in France and Spain, e.g.) the assets (the cover) must be listed in a register. National mortgage legislation differs widely in the range of flexibility granted to the banks for (re-)structuring and administering the cover.

Table 2

Covered bond legislation in Europe: ceilings, coverage and supervision

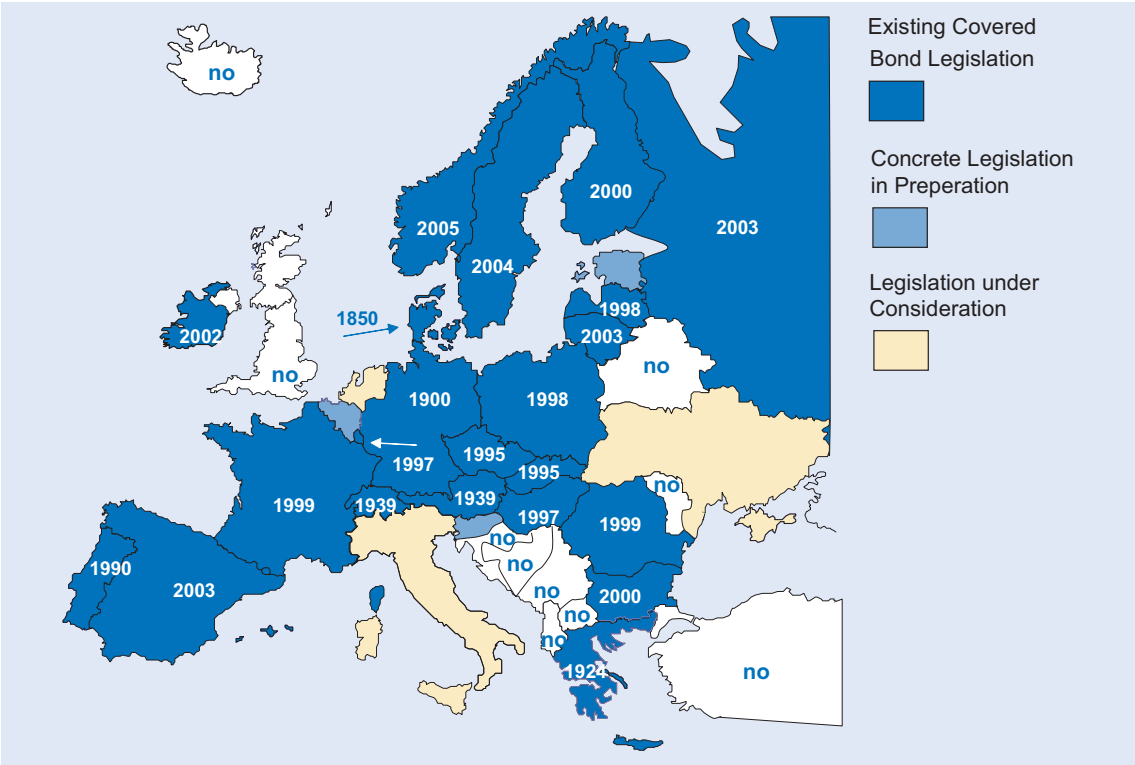
	Absolute lending ceiling	Non-cover limit (volume above the relative lending ceiling)	Trustee	Substitute coverage	Substitute coverage limit	Public sector bond	Special public supervision	Compliance with Art. 22 (4) of UCLIS[a)] regulation
Denmark	Yes	Not permitted	No	No	No	No	Yes	Yes
Germany	Basically no (100% of market value)	20%	Yes	Yes	10%	Yes	Yes	Yes
Greece	75% of market value	Not allowed	No	No	No	No	Yes	Yes (but unsure)
Austria	No	No	Yes	Yes	No	Yes	Yes	Yes
Switzerland	No	No	No	Yes	No	No	Yes	Yes
Spain	No	No	No	No	No	Yes	Yes	Yes
Portugal	No	No	No	Yes	No	No	Yes	Yes
Sweden	No	No	No	No	No	No	No	No
Czech Republic	No	No	No	Yes	10%	No	Yes	Yes
Slovak Republic	No	10%	Yes	Yes	10%	Yes	Yes	Yes
Hungary	10% of value of collateral	No	Yes	Yes	20%	No	Yes	Yes
Luxembourg	Basically no (market value?)	No	Yes	Yes	20%	Yes	Yes	Yes
Poland	100% of value of collateral	30%	Yes	Yes	10%	Yes	Yes	Yes
Latvia	No	No	No	Yes	20%	Yes	Yes	Yes
France	60/80/100% of value of collateral/ market value	No	Yes	Yes	20%			
Romania	No	Unlimited	No	No	No	No	No	No
Finland	Basically no (market value?)	1/6	No	Temporary	No	Yes	Yes	Yes
Bulgaria	No	No	Basically no	Yes	30%	No	Unclear	Unclear
Ireland	Yes (80% of cautious market value)	Yes (10%)	Yes	Yes	20%	Yes	Yes	Yes
Lithuania	No	No	No	Yes	10%	No	Yes	Yes
Russia	No	No	Yes	Yes	20%	No	Yes	Yes
Norway	60% of market value	Not permitted	Yes	Yes	Proposal: 30% regulation of the supervisory authority (substitute coverage and derivatives)	Yes	Yes	Yes
United Kingdom	No specific legal provision for covered bonds							
United States	No specific legal provision for covered bonds							

[a)] EU Directive on Undertaking for Collective Investment in Transferable Securities (UCITS).

Sources: Association of German Mortgage Banks (2004); Hagen, L. (2004).

Figure 2

COVERED BOND LEGISLATION IN EUROPE



6. In case of insolvency of the issuer (i.e. the mortgage bank) all countries grant special privileges to the covered bond investor (holder of the bonds). In Germany, Sweden, Finland and Bulgaria the regulation is most favourable for the investor because the cover assets are legally separated. In all other countries the cover assets form part of the insolvency estate but the holders of covered bonds have insolvency privilege.

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