

3.17 ICELAND

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I. FRAMEWORK

In Iceland, the issuance of covered bonds is governed by the Icelandic Covered Bond Act, which came into force on 20 March 2008 (Lög nr. 11/2008 um sértryggð skuldabréf, hereinafter the “**ICBA**”). The ICBA supersedes the general bankruptcy law to the extent that it grants covered bond investors a priority claim on eligible cover assets (ICBA: Chapter VII). Rules of the Financial Supervisory Authority no. 528/2008 (Reglur nr. 528/2008, hereinafter the “**ICBR**”) established by the Icelandic Financial Supervisory Authority (Fjármálaeftirlitið, hereinafter the “**FME**”) complement the legislation. These rules define in more detail the criteria for obtaining a covered bond issuance licence, the universe of eligible cover assets, valuation procedures for eligible cover assets, asset and liability management, and the form and maintenance of the cover register.

II. STRUCTURE OF THE ISSUER

The FME grants licences for the issuance of covered bonds. Licences to issue covered bonds can only be granted to licenced commercial banks, savings banks and credit undertakings. To qualify as an issuer, certain criteria must be met. These criteria include the submission of a financial plan, confirmed by a state authorised public accountant, proving the issuer’s financial stability and that the issuance is in accordance with the ICBA. The FME has the right to withdraw the licence should the issuer be in material breach of the ICBA or if the issuer has failed to issue covered bonds within one year of receiving the licence (Table 1).

> TABLE 1: LICENCE NEEDED TO ISSUE COVERED BONDS

Requirements for issuance licence

- > Issuer must supply the FME with a board resolution that the board approves the application for a covered bond licence.
- > Description of the proposed bond issuance and how the issuer intends to keep and organise the covered bond register.
- > Information about the covered bond register, e.g. how the issuer will maintain the register as well as how the register will be supervised.
- > The FME can allow an issuer to convert previously issued bonds used to finance assets that are eligible under ICBA into covered bonds.
- > The issuer well plan, confirmed by a public accountant, proving the issuer’s financial stability for at least the next three years; a description of the proposed covered bond issuance and how the issuer intends to organise and administrate the covered bond issuance; and the covered bond register as well as written confirmation from the issuer that he and the planned bond issue comply with the ICBA and ICBR.
- > The issuer must submit information about IT systems used in relation to the covered bond issuance.
- > The issuer must submit any other information that is relevant for the proposed bond issuance.
- > A written statement from the issuer that it and the issue fulfil the requirements made by the ICBA and the ICBR.

The cover assets represent a claim of the covered bond issuer and remain on the balance sheet. There is no subsequent transfer of cover assets to another legal entity. The covered bonds are direct, unconditional ob-

ligations on the part of the issuer. Outstanding covered bonds are backed in their entirety by the cover pool. Hence, there is no direct legal link between a single cover asset and a particular covered bond series. In the event of issuer insolvency, the cover pool is bankruptcy remote from the general insolvency estate of the issuer and exclusively available to meet outstanding claims under the issue of the covered bond investors. It should also be noted that the covered bond investors enjoy recourse to the insolvency estate of the issuer, ranking pari passu with senior unsecured investors.

III. COVER ASSETS

Eligible assets in the covered bond register are mortgage loans and public sector assets (ICBA Chapter II, Article 5). The ICBA does not require a separate cover pools for mortgage and public sector cover assets. Both asset classes can be mixed in one cover pool. Icelandic covered bond issuers have issued covered bonds where the asset register consists exclusively of residential mortgages.

Eligible assets ("**Cover Assets**") according to ICBA are:

- > Mortgages secured by residential housing in member states¹;
- > Mortgages secured by industrial, office or commercial property in member states;
- > Mortgages secured by farms and other real estate used for agricultural purposes in member states; and
- > Public sector assets defined as bonds issued by the Icelandic state or other member state, a municipality in Iceland or in another member state, or guaranteed by such public authority.

Derivative contracts

The ICBA authorise the use of derivatives for hedging interest and currency risk. The derivatives must be structured such that premature termination is not triggered by an issuer default or a demand by the counterparty. Derivative counterparties must have a rating from a rating agency approved by the FME. The minimum is a long-term rating of A3/A-/A- (Moody's/S&P/Fitch) or short-term rating of P2/A2/F2. If the counterparty's rating falls below the minimum level, the issuer of covered bonds can:

- > Request additional collateral;
- > Terminate the derivative contract and open a new derivative contract with a counterparty that meets the minimum rating requirement, or;
- > Request that the counterparty provides a guarantee from a third party that meets the minimum rating requirement.

Substitute assets

The ICBA allows for the inclusion of the following assets as Substitute Collateral (Article 6):

- > Demand deposits with a regulated financial undertaking;
- > Deposits with or claims against a member state or a central bank in a member state;
- > Claims against other legal entities which, the FME views as not involving greater risk than the aforementioned options.

Further, FME may approve the following as substitute collateral:

- > Claims against municipalities in member states;
- > Claims against a regulated financial firm other than demand deposits with a regulated financial undertaking (as referred to above), provided the final maturity of the claim is within one year of issuance;

¹ Member state: a state which is a party to the Agreement on the European Economic Area.

- > Claims against non-Icelandic development banks listed in rules adopted by the FME;
- > Claims against other legal entities which do not involve greater risk than the substitute collateral referred to in other items of this paragraph.

It should be noted that Substitute Collateral may not comprise more than 20% of the value of the cover pool. The FME may however authorise an increase in the proportion of substitute collateral in the cover pool to as much as 30% of its value.

IV. VALUATION AND LTV CRITERIA

The ICBA defines valuation principles for the properties that are used as a Cover Assets (ICBA: Chapter III, Article 7). An assessment of the market value of real estate shall be based on the selling price in recent transactions with comparable properties. If the market value of real estate is not available, it shall be determined by a specific valuation. The valuation shall be based on generally accepted principles for market valuation of real estate. Among the data that can be used as a basis is data on real estate price developments from the Land Registry of Iceland, together with other generally accepted systematic collection of real estate price data.

If an issuer assesses the market value of real estate, the Independent Inspector (as defined below) must verify that the appraisal is based on a generally accepted methodology. The Independent Inspector may re-assess the market price of one or more properties if he/she regards the valuation as incorrect.

An appraisal of the market value of real estate must be in writing and must specify the methodology used, who carried out the appraisal and when it was made.

For the various mortgage types eligible as Cover Assets, the maximum LTV ratios apply (ICBA: Chapter III, Article 7):

- > 80% of the value for real estate.
- > 70% of the value for real estate intended for agricultural use (some restrictions apply).
- > 60% of the value for real estate, where the property is intended for office or commercial use.

V. ASSET – LIABILITY MANAGEMENT

The ICBA requires that the nominal value of the Cover Assets at all times exceed the aggregate nominal value of claims arising from outstanding covered bonds against the issuer (ICBA: Chapter V, Article 11). In addition, the law requires that on a net present value (NPV) basis, cover assets, including derivatives, always exceed the corresponding value of the interest and principal of outstanding covered bonds, taking into account the effects of stress-test scenarios on interest and currency risk set by the FME. The FME defines the stress test for interest-rate risk as a sudden and sustained parallel shift in the reference curve by 100bps up and down. The reference curve is based on Icelandic government bonds for covered bonds in Icelandic krona but swap rate curves for other currencies. Likewise, it defines currency risk as a 10% sudden and sustained change in the relevant foreign exchange rate between the currency of covered bonds and the currency of cover assets (ICBR: Chapter 4, Article 8). The ICBA does not require a mandatory level of minimum overcollateralisation (“OC”). However, the issuer can adhere to a self-imposed OC level for structural enhancement, as the ICBA protects any OC in the cover pool in the event of issuer insolvency.

Finally, the issuer shall ensure that the cash flow with respect to the Cover Assets, derivatives agreements and the covered bonds are such that the issuer is always able to meet its payment obligations towards holders of covered bonds and counterparties in derivatives agreements (ICBA: Chapter V, Article 12). The issuer should be able to account for these funds separately.

VI. TRANSPARENCY

The issuers currently present information regarding their cover pool and outstanding covered bonds on a monthly or at least on quarterly basis. This information is currently available on the issuer's website.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Issuers of covered bonds fall under the supervision of the FME, which monitors the issuers' compliance with the ICBA and other related regulatory provisions (e.g. ICBR). If a covered bond issuer is in a material breach of its obligation under the legal framework, the FME can give the issuer a formal warning or revoke the issue license altogether. The FME may also revoke a license if the institution has declared that it has no intention to use the licence to issue covered bonds or if the institution has not made use of the license within a year from the date of receiving the license. The revocation may be combined with an injunction against continuing the operations and with the imposition of a conditional fine. In any case, the FME must determine how the operations should be wound up (ICBA: Chapter IX, Articles 24–29).

Each issuer, must appoint an independent and suitably qualified cover pool inspector (the "**Independent Inspector**") and such appointment must be validated by the FME. The duties of the Independent Inspector are to monitor the register and verify that the covered bonds, the derivatives agreements and the Cover Assets are correctly recorded. The Independent Inspector also ensures compliance with matching and market risk limits in accordance with ICBA. The institution is obliged to provide the Independent Inspector with any information requested relating to its covered bond operations. The Independent Inspector must submit a report of the inspection to the FME on an annual basis and must notify the FME as soon as he/she learns about an event deemed to be significant to the supervisory authority (ICBA: Chapter VII, Articles 21–23).

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Cover register

The issuer must keep a detailed register of Cover Assets derivative contracts and outstanding covered bonds (ICBA: Chapter VI, Section 13). The law further specifies the form and content of such a register, which must be easily accessible to the FME and the Independent Inspector. The registration legally secures covered bond holders and derivatives counterparties a priority claim on the cover pool in the event of issuer insolvency (ICBA: Chapter 7, Section 15). Prior to an issuer being declared insolvent, cash flows accruing from the Cover Assets must be accounted for separately by the issuer. In the event of issuer default, covered bond investors and derivative counterparties have the same priority claim on these funds as they have on the cover pool. Moreover, cash flow accruing from the Cover Assets following issuer insolvency must be registered in the cover pool.

Issuer insolvency

In the event of issuer insolvency, the Cover Assets and the respective covered bonds are segregated from the insolvency estate of the issuer. An issuer default does not trigger the premature termination of registered derivative contracts. Covered bond holders and registered derivative counterparties have a priority claim on the cover pool and cash that derives from the pool, ensuring timely repayment to original agreed terms, as long as the pool complies with the ICBA. It should be noted however, that the cover pool does not constitute a separate legal estate.

Cover pool insolvency and preferential treatment

In the event that the cover pool breaches eligibility criteria, covered bonds are accelerated. Covered bond investors and derivative counterparties would have priority claim on the proceeds from the sale of the cover assets, ranking *pari passu* among themselves. If the proceeds are insufficient to repay all liabilities on outstanding covered bonds, covered bond investors and derivative counterparties have an ultimate recourse to the insolvency estate of the issuer, ranking *pari passu* with senior unsecured investors.

Survival of OC

Any OC present in the cover pool at the time of issuer insolvency is bankruptcy-remote provided it is identified in the cover pool register. Indeed, the CBIA requires full repayment of outstanding claims on covered bonds and registered derivatives before Cover Assets are available to satisfy claims on unsecured creditors. The law does not provide for the appointment of a special cover pool administrator in case of issuer insolvency. The receiver-in-bankruptcy represents the interest of both the covered bond investors and the unsecured investors. The receiver has the right to use OC to pay advance dividends to other creditors of the bankrupt issuer if the pool contains more assets than necessary. If the Cover Assets later prove to be insufficient, these advance dividend payments can be reclaimed.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the Capital Requirements Regulation (CRR²). Icelandic covered bonds comply with the criteria of Article 52(4) UCITS and with the covered bond criteria defined in Article 129(1) CRR. The ICBA explicitly lists mortgages against property for agricultural purposes and mortgages against the pledging of tenant-owner rights as eligible cover assets, while the CRR does not. In addition, issuers can impose self-restrictions to ensure that their covered bond issues comply with the CRR. Icelandic covered bonds are not eligible for repo transaction with the Icelandic Central Bank.

X. ADDITIONAL INFORMATION**Legislative covered bonds in Iceland**

Arion Bank and Íslandsbanki were both granted a licence to issue covered bonds under ICBA in the fall of 2011 and both followed up by issuing covered bonds denominated in Icelandic krona to domestic investors. Landsbankinn was granted a licence to issue covered bonds in April 2013 and issued their first covered bonds in June 2013. The banks use their covered bond programs to fund their residential mortgage portfolios.

A specific attribute of the Icelandic mortgage market is that the largest majority of Icelandic mortgages are inflation linked. This means that the principal of each mortgage follows the changes in consumer prices in Iceland. This has changed since 2011 when the banks started to offer fixed rate loans that were not tied to inflation. Normally, the bonds are registered at the Nasdaq OMX Iceland (NASDAQ OMX Group) or another European stock exchange.

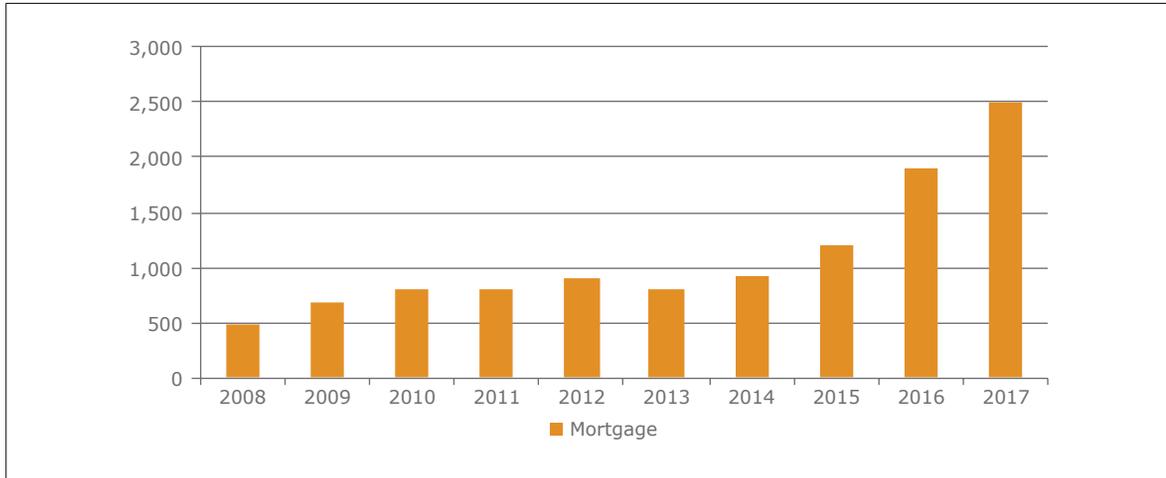
Covered bonds in Iceland prior to the financial crisis of 2008

The legislation on covered bonds (ICBA) came into force in March 2008 only a few months before the collapse of the Icelandic financial system in October month of the same year. Covered bonds based on the legislation had not been issued prior to the crisis of 2008 although one bank had been granted a licence from the FME to issue covered bonds without ever issuing bonds.

Both Glitnir and Kaupthing bank and other smaller financial institutions set up structured covered bond programs in 2006 and 2007. The bonds issued under the programs were mainly used as collateral in repo transactions with the Central bank of Iceland and/or other counterparties. A small minority of these bonds was sold to other investors. The holders of such structured covered bonds did not take a loss on their holding despite the bankruptcy proceedings of the issuers. The largest of these structured covered bond programs was the Kaupthing ISK 200 bn covered bond program that was restructured in late 2011 when Arion bank took over as issuer and acquired the mortgages under the program. Total outstanding Arion Bank structured covered bonds is EUR 629 million as of 31 December 2016.

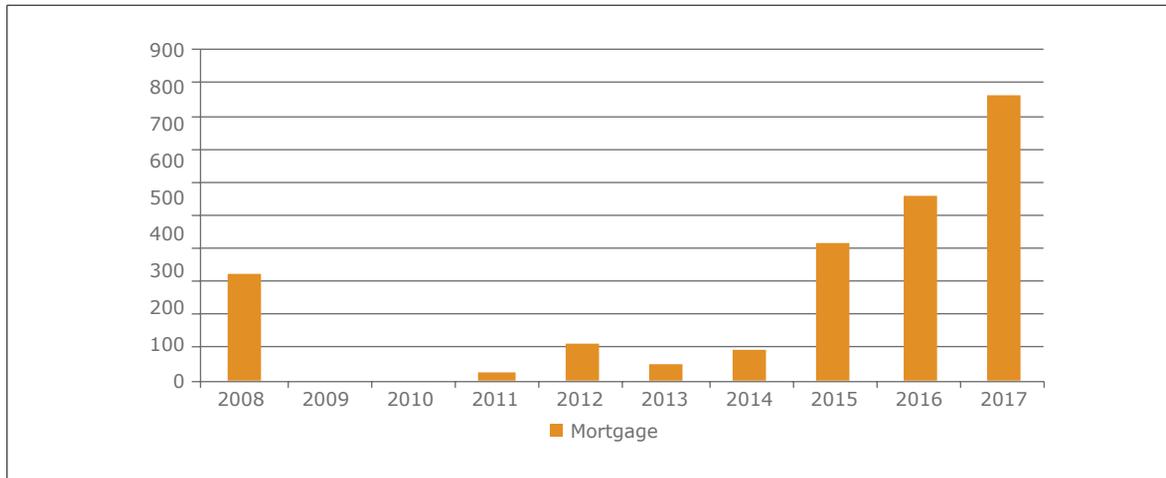
² Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): <https://hypoc.org/ecbc/covered-bonds/>.

> FIGURE 2: COVERED BONDS OUTSTANDING, 2008-2017, EUR M



Source: EMF-ECBC

> FIGURE 3: COVERED BONDS ISSUANCE, 2008-2017, EUR M



Source: EMF-ECBC

Issuers: There are currently three issuers in Iceland – Arion Bank, Íslandsbanki and Landsbankinn.

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/108/Icelandic_Covered_Bonds.