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I. FRAMEWORK

Since 2012, covered bonds in Slovenia are governed primarily by the Mortgage Bond and Municipal Bond Act (Official Gazette of the Republic of Slovenia no. 10/12 and no. 47/12; "the Covered Bond Act"). In addition, general rules of the Financial Instruments Market Act (Official Gazette of the Republic of Slovenia no. 67/07 and amendments), the Banking Act (Official Gazette of the Republic of Slovenia no. 25/15, 44/16 and 77/16), the Resolution and Compulsory Dissolution of Credit Institutions Act (Official Gazette of the Republic of Slovenia no. 44/16 and 71/16) and the Consumer Credit Act (Official Gazette of the Republic of Slovenia no. 77/16) are to be applied (Article 6 of the Covered Bond Act).

The Bank of Slovenia¹ ("BoS") issued further relevant by-laws, namely the Regulation on the Conditions for Obtaining an Authorisation for Issuing Mortgage and Municipal Bonds, the Regulation on Matching the Cover Pool with the Outstanding Mortgage and Municipal Bonds, the Regulation on the Conditions for Inclusion of Derivative Instruments in the Cover Pool of Mortgage and Municipal Bonds and the Regulation on the Documentation for Proving the Fulfilment of Conditions for the Cover Register Administrator Appointment (all four regulations published in the Official Gazette of the Republic of Slovenia no. 17/2012). In addition, the Governing Board of the BoS adopted Recommendations for Managing the Records of the Cover Register as of 28th February 2012.

Although the Covered Bond Act altogether with the Regulations of the BoS represents a modern and suitable legal framework for the issuance of covered bonds in Slovenia, there have been no covered bond issuances from the Slovenian market yet.

II. STRUCTURE OF THE ISSUER

Covered bonds can be issued by banks holding a valid banking license and which are authorised from the Bank of Slovenia to issue mortgage covered bonds or public sector covered bonds.

In order to obtain a special license for the issuance of covered bonds, an issuing bank must prove that it fulfils the following conditions, set out in Article 9 of the Covered Bond Act:

- > Suitable risk management procedures and instruments associated with the issuance of covered bonds as well as with the cover pool assets;
- > Adequate number of qualified staff and ability to be organisationally and technically qualified to issue mortgage or public sector covered bonds and to finance the real property, owned by entities, governed by public law, and other legal entities;
- > Separation of services related to the issuance of covered bonds and to the covered assets from the bank's other operations;
- > Rules for maintaining the cover register;
- > Rules for property valuation and at least one independent valuer.

III. COVER ASSETS

Only receivables from mortgage loans and loans that are secured by an eligible state or a local community, that are compliant with provisions of the Covered Bond Act, can be considered as the cover assets for covered bonds.

¹ The Central Bank of the Republic of Slovenia.

The cover assets of mortgage covered bonds can consist of receivables arising from (i) loans secured by a mortgage on residential property that is located in the EEA or Switzerland, (ii) loans secured by a mortgage on commercial property that is located in the EEA or Switzerland (up to 20% of the cover assets).²

The cover assets of public sector covered bonds can consist of receivables arising from (i) loans granted to or debt securities issued by an eligible state³ or an eligible local community⁴, (ii) loans granted to or debt securities issued by another legal entity provided that the obligations in respect to such loans or securities are irrevocably and unlimitedly guaranteed by an eligible state.

Up to a maximum of 20% of the cover pool can be provided by substitute cover assets. Eligible assets are (i) balances on the accounts with the BoS, (ii) investments in marketable debt securities issued or guaranteed by an EEA member state and Switzerland or their central banks or ECB, or (iii) investments in other debt securities issued by EIB, EBRD or any other bank, provided that they are used as the collateral for receivables in accordance with the ECB's criteria, published in the Articles of Association governing the European System of Central Banks (Article 20 of the Covered Bond Act).

Additionally, an issuer can also include derivative financial instruments in the cover pool (up to 12%) in order to reduce/hedge the market risks on its assets, in particular the risks associated with interest rate and currency mismatch.

Finally, an issuer must take into account also the following limitations according to Article 25:

- > Up to 5% of the cover assets can consist of mortgage loans secured by a mortgage on residential property under construction;
- > Up to 10% of the cover assets can consist of mortgage loans secured by a mortgage the registration of which is still pending, provided that the process of registration in the Slovenian land register is completed within 12 months from the date of filing the application;
- > Up to 20% of the cover assets can consist of mortgage loans granted to an individual or to legal entities which are considered as a group of related parties in accordance with the Banking Act; nevertheless, the bank's exposure to these entities must not exceed the maximum admissible exposure set out in the Banking Act.

IV. VALUATION AND LTV CRITERIA

The level of receivables from mortgage loans that can be taken into consideration for the cover assets must not exceed: (i) 80% of the mortgage lending value of mortgaged property or, in case the general market value is used, 50% of the general market value of property for loans secured by mortgage on residential properties; (ii) 60% of the mortgage lending value of mortgaged property for loans secured by mortgage on commercial properties. When the level of receivables from mortgage loans exceeds the above restrictions, only an appropriate portion of the loan can be considered as eligible cover assets (Article 28 of the Covered Bond Act).

Generally, a valuation of residential and commercial property is based on the mortgage lending value.⁵ However, if the latter cannot be determined, the market value is used instead. It is important to note that a valuation must be performed by an independent property valuer and in compliance with the international property valu-

2 As stipulated in Article 19 (3) of the Covered Bond Act, only receivables from first ranking mortgage loans or lower ranking mortgage loans provided that the issuer also holds the prior-ranking claims are eligible for mortgage cover pools.

3 An eligible state is (i) the Republic of Slovenia and (ii) an EEA member state and (iii) Switzerland, whose credit rating is equal to or higher than the Eurosystem's credit rating threshold, established by the BoS.

4 An eligible local community is a local community (i) in the Republic of Slovenia and (ii) in an EEA member state and (iii) Switzerland, whose credit rating is equal to or higher than the Eurosystem's credit rating threshold, established by the BoS.

5 The methodology for determining the mortgage lending value is established by property valuation rules, adopted by each individual issuer (Articles 26 and 29 of the Covered Bond Act).

ation standards, adopted by the IVSC (Article 26 (4) of the Covered Bond Act). However, as regards residential property, also the general market value, estimated by using the mass appraisal methods, can be used (Article 27 of the Covered Bond Act).

A value of property is determined individually for each real property. During the property mortgage loan term, an issuer must regularly monitor the value of mortgaged property and re-assess this value at least once a year for commercial property and at least once every three years for residential property. In addition, a need for a new valuation of the property also arises when a value of real property and/or general market prices of real properties in the area where the real property is located drop substantially (by more than 20%), or when a borrower is late in meeting his obligations under the mortgage loans by more than 90 days (Article 30 of the Covered Bond Act).

V. ASSET – LIABILITY MANAGEMENT

Article 22 of the Covered Bond Act states, that covered bonds can only be issued to the level that still ensures full coverage of liabilities stemming from outstanding bonds and derivative financial instruments by means of cover assets at all times and in at least the same aggregate nominal amount. Additionally, the matching of cover assets with the liabilities stemming from covered bonds and derivative financial instruments must be at all times ensured also according to the present value principle⁶. In this case, the cover assets' present value must exceed the present value of liabilities stemming from covered bonds by the minimum legal overcollateralisation requirement of 2%. Furthermore, cover assets need to be matched with liabilities stemming from issued covered bonds and derivative financial instruments also in terms of maturities, interest rates and currency exposure.

The compliance with the above-mentioned conditions must be verified at least once a month. In addition, stress tests (e.g. tests of the impact of a change in interest rates and foreign exchange rates) must be performed monthly too. If the present value of cover assets does not exceed the present value of covered bonds by at least 2%, an issuer must immediately start with the activities to increase cover assets accordingly (Articles 4-7 of the Regulation on Matching the Cover Pool with the Outstanding Mortgage and Municipal Bonds).

Additionally, an issuer must compare the amount of matured receivables from the cover assets entered in the cover register with the amount of matured liabilities stemming from the issued covered bonds and from the derivative financial instruments entered in the cover register over the next 180-day period on a daily basis. Subsequently it must provide the coverage in a form of the substitute cover assets following the comparison of the largest calculated difference between the matured liabilities and the matured receivables (the so-called cover assets reserves) (Article 23 of the Covered Bond Act).

VI. TRANSPARENCY

According to the Covered Bond Act (Article 52), issuers are obliged to report to the Bank of Slovenia an extract from the cover register on a quarterly basis. In addition, the issuer's annual report shall also contain information on the cover pool assets, e.g. the number and category of mortgage loans or the area in which the real estate property is located.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Cover register

Each issuing bank needs to keep a cover register (Article 37 (1) of the Covered Bond Act). In case of issuing both mortgage and public sector covered bonds, a bank must keep two separate cover registers (Article 51 (2) of the Covered Bond Act).

⁶ In case of the derivative financial instruments the fair value principle is used instead of the present value principle (Article 3 (3) of the Regulation on Matching the Cover Pool with the Outstanding Mortgage and Municipal Bonds).

The cover register contains the receivables and investments that represent cover assets for the issued mortgage and municipal bonds (public sector covered bonds) as well as the record of all mortgage and municipal bonds issued, all of them clearly individualised. Moreover, it must reveal the nominal value of the cover assets and mortgage/municipal bonds in circulation at all times (Article 37 (2-4) of the Covered Bond Act).

Cover register administrator

A cover register administrator ensures that the cover register is maintained in accordance with the provisions of the Covered Bond Act and its related Regulations. Only a person that is a certified auditor or an otherwise qualified expert that was previously being granted a licence from the BoS to perform the tasks of a cover register administrator can be appointed as a cover register administrator. Moreover, such a person must also be independent from the issuer (Articles 39 and 40 of the Covered Bond Act).

The duties and obligations of a cover register administrator are as following (Articles 38 (1-3), 41 and 42 of the Covered Bond Act):

- > To ensure that the cover assets provide a sufficient coverage for the total value of the covered bonds in circulation and liabilities stemming from derivative financial instruments and to notify the BoS without any delay if he considers such a coverage to be unsatisfactory;
- > To ensure that the assets are recorded in the cover register in accordance with the Covered Bond Act;
- > Prior to the issuance of covered bonds, to confirm that the cover assets provide a sufficient and adequate coverage for covered bonds;
- > To give consent to the issuer's request for a cancellation of a mortgage in the Slovenian land register that serves as a security for the claims, entered as a coverage in the cover register;
- > To regularly notify the BoS of its findings pursuant to the Covered Bond Act;
- > To examine the books of account and other documents of the issuer that could be in any way associated with covered bonds and cover assets;
- > To require from an issuer to keep him regularly informed of the performance of the cover asset-related repayments and any other changes, associated with these assets.

Replacement of inadequate assets

A cover register administrator must require from an issuer to replace receivables from inadequate mortgage loans with receivables from other mortgage loans or other suitable assets if (i) during the term of the mortgage loan the value of real property declines to such an extent that the value of the outstanding mortgage loan exceeds the legally prescribed level of mortgage lending value or the real property's general market value; (ii) the borrower falls behind in meeting its payment obligations under the loan agreement for more than 90 days; or (iii) the time limit for entering the mortgage in the Slovenian land register expires.

In case of a decline in the real property's general market value an issuer may nonetheless supplement existing receivables from mortgage loans by receivables from other mortgage loans or other suitable assets to the minimum extent of the deficit in the cover assets resulting from a decline in the real property's value (Article 31 of the Covered Bond Act).

Role of the BoS

The BoS carries out a constant supervision on the implementation of the Covered Bond Act (Article 53 of the Covered Bond Act). In addition, it grants and withdraws the licence, given to a bank prior to the issuance of covered bonds, as well as it grants and withdraws the license granted to a cover register administrator.

An issuer is required to send to the BoS an extract from the cover register, signed by a cover register administrator, every three months (Article 52 (1) of the Covered Bond Act). Similarly, a cover register administrator and a cover assets trustee have to report to the BoS both on a regular basis and on request.

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

Segregation of cover assets

Cover assets, entered in the cover register, remain the property of an issuer and are intended primarily for the payment of obligations under covered bonds and derivative instruments that are included in the cover assets (Article 3 (1) of the Covered Bond Act). Moreover, (substitute) cover assets must be free from any encumbrances and cannot be used or pledged for any other purpose (Articles 19 (4) and 20 (2) of the Covered Bond Act).

The issuer must further ensure that services related to granting mortgage loans and loans to entities governed by public law as well as services related to the issuance of mortgage and municipal bonds are conducted separately from the bank's other operations. This encompasses also separate keeping of the books of account, other records and documents (Articles 9 (1) and 10 of the Covered Bond Act).

Only the obligations of the issuer under covered bonds and derivative financial instruments can be enforced against the cover assets (Article 37 (5) of the Covered Bond Act). The law also limits the type of claims that can be – under certain conditions – subject to set-off rights of debtors and their guarantors whose liabilities are included in the cover pool (Article 37 (6) of the Covered Bond Act).

Bankruptcy remoteness of covered bonds

Cover assets are part of the general estate of a bank as long as an issuer is solvent. Upon the commencement of the issuer's insolvency proceedings⁷, the cover assets are automatically separated from the issuer's general insolvency estate. Moreover, covered bond holders and creditors under derivative financial instruments have a primary secured claim (costs included) against all assets in the cover pool. However, in their mutual relationship holders of covered bonds and creditors under derivative financial instruments have the same order of priority (i.g. rank *pari passu*) (Articles 44 (1, 3) and 45 (1, 2) of the Covered Bond Act).

It is important to note that covered bonds and derivative financial instruments do not automatically accelerate as soon as an issuer is insolvent. On the contrary, they are repaid at the time of their contractual maturity. On the proposal of the BoS the insolvency court appoints a cover assets trustee (who must not be the same person as an issuer's insolvency administrator) and he deals with the management and disposal of the cover assets to the extent that is necessary for the continuous timely payment of obligations under covered bonds and derivative financial instruments. Moreover, a covered assets trustee is entitled to obtain liquidity loans in order to ensure continuous compliance with the payment obligations under covered bonds and derivative financial instruments for what no approval of the insolvency court is needed. Only if the redemption of covered bonds prior to their maturity will result in better terms for repayment of the issuer's obligations under covered bonds and derivative financial instruments, a cover assets trustee may ask the insolvency court for approval on the acceleration (Articles 18 and 47 (1-3) of the Covered Bond Act).

In case that the cover assets prove insufficient to ensure the continuous payment of obligations under covered bonds and derivative financial instruments, a separate insolvency proceeding is initiated against the cover assets on the request of the BoS. Moreover, if such separate insolvency proceedings still do not result in a full payment of the obligations under covered bonds and derivative financial instruments, the holders of covered bonds and the creditors under derivative financial instruments are entitled to lodge a claim for the remaining part of their receivables in the issuer's general insolvency proceedings (Article 49 (1-3) of the Covered Bond Act).

⁷ Similarly, in case of the withdrawal of the licence to issue covered bonds (Article 15 of the Covered Bond Act).

It should be added that an issuer's insolvency administrator is entitled to request the cover assets trustee to transfer to the issuer's insolvency estate a certain part of the cover assets that will, beyond any doubt, not be required for the payment of obligations under covered bonds and derivative financial instruments, included in the cover pool. The final decision on the transfer is made by the insolvency court. Furthermore, when all the obligations under covered bonds and derivative financial instruments have been paid, a cover assets trustee nevertheless transfers the remainder of the cover assets to the issuer's insolvency estate (Article 47 (5-7) of the Covered Bond Act).

Finally, the cover assets trustee can transfer the entire cover pool and all obligations arising out of the issued covered bonds to other issuer by a way of contract. A full transfer must be authorised by the BoS (Article 48 of the Covered Bond Act).

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

With the new Banking Act, adopted in May 2015, the Regulation on the Calculation of Capital Requirements for Credit Risk under the Standardised Approach for Banks and Savings Banks and the Regulation on the Calculation of Capital Requirements for Credit Risk under the Internal Ratings Based Approach for Banks and Savings Banks (both published in the Official Gazette of the Republic of Slovenia no. 135/06) ceased to be valid. Since then, the risk-weighting of covered bonds in Slovenia is regulated directly by Capital Requirements Regulation (CRR).

The provisions of the Covered Bond Act fall within the criteria of Article 129 (1) CRR as well as within the criteria of Article 52 (4) of the UCITS Directive.⁸

ECBC Covered Bond Comparative Database: http://www.ecbc.eu/framework/110/Slovenian_Covered_Bonds.

⁸ Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): <https://hypo.org/ecbc/covered-bonds/>.