

## **3.10 CZECH REPUBLIC**

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### **I. FRAMEWORK**

It has been possible to issue the mortgage Covered Bonds ("Hypotecni zastavni list" – hereinafter referred to as "MCB") in the Czech Republic from 1 January 1992 on the basis of the general regulation contained in the Commercial Code.

At present, the MCBs, the mortgage loans (hereinafter also referred to as "ML") and the other terms and conditions of mortgage financing are regulated in detail in the Bond Act (hereinafter also referred to as "BA"), which entered into force on 1 April 2004. The latest amendment has been effective since 1 August 2012, which, besides other things, enables issuance of the MCBs under a law different from the Czech law and clarifies the calculation of the minimum LTV required by the law.

Specific provisions treating cover assets and applicable at the opening of the insolvency proceedings or declaration of bankruptcy of the issuing bank are part of the Insolvency Act No. 182/2006 Coll.

An initiative sponsored and coordinated by the Czech Banking Association aiming for the improvement of the covered bond legislation was launched in December 2012. The initiative prepares proposals for legislative changes, which should help to further promote soundness of the Czech covered bond market. The Bond Act and Insolvency Act are within the scope of this initiative.

In May 2018, the amendment of the Bond Act is within the approval process in the Parliament. Main features of the proposed amendment are the abolishment of automatic acceleration of covered bonds, better recognition of overcollateralising assets for the benefit of covered bond holder, possibility to have more than one cover pool, and to include derivatives in cover pools. New legislation is expected to become valid in the first half of 2019.

### **II. STRUCTURE OF THE ISSUER**

MCBs may only be issued by a bank holding a Czech banking license (i.e., a banking license issued under the Banking Act no. 21/1992) and having its registered office in the Czech Republic (an "Issuing Bank"). An Issuing Bank can generally pursue all business activities that are permitted for credit institutions and need not be a specialised bank. The MCBs constitute direct and unconditional obligations of the Issuing Bank, and the Issuing Bank is fully liable for any payment obligations thereunder. All obligations arising from the MCBs are obligations of the Issuing Bank as a whole to be paid from all the assets of the Issuing Bank, subject to specific provisions applicable to the Issuing Bank's insolvency (dual recourse).

### **III. COVER ASSETS**

Pursuant to the BA, the MCBs are such covered notes where the nominal value of and revenue from which are fully covered with (i) receivables from MLs or parts of these receivables (the so-called "regular coverage") and (ii) by substitute collateral. The text "Mortgage Covered Bond" has to be a part of the name of this covered bond. No other securities and/or covered bonds are allowed to use this name.

ML is such loan that is secured with a mortgage to a real estate (residential mortgages, commercial mortgages, land, buildings under construction). The amount of receivables from ML must not exceed double the collateral value of the mortgaged real estate. The real estate under the mortgage right has to be located on the territory of the Czech Republic, a member state of the European Union or another country making a part of the European Economic Area. The loan is considered to be the mortgage loan on the day of origin of legal effects of the mortgage right registration.

The mortgage right securing the ML used to cover the MCBs has to be in the first position in the Real Estate Register. There are two exceptions to this rule: the real estate under mortgage may have a priority mortgage right securing a loan which:

- > Is extended by a building society or a loan extended for a cooperative housing construction supported by the State. The precondition for this is that the building society or the creditor of the cooperative housing construction loan that have the priority sequence of the mortgage right have given a written consent to the issuer of MCBs to establish the mortgage right in a lower ranking. The receivable from the ML secured with a mortgage right not in the first position may not be used to cover the MCBs without such consent.
- > Will be repaid so that the mortgage right related to the ML will move from the second position to the first position of registration in the Real Estate Register.

#### **Substitutive Coverage**

Substitute collateral is restricted to 10% of the nominal amount of MCBs outstanding. The following substitute assets are eligible:

- > Cash;
- > Deposits of the issuer at the Czech National Bank (hereinafter referred to as "CNB");
- > Deposits at the Central Bank (National Bank) of a member state of the European Union or another country making a part of the European Economic Area or at the European Central Bank;
- > Government bonds and/or securities issued by the CNB;
- > Government bonds and/or securities issued by the member states of the European Union or by other countries making a part of the European Economic Area, their Central (National) Banks and the European Central Bank; and
- > Government bonds issued by the financial institutions established with an international agreement the contracting party of which is the Czech Republic, or the financial institutions with which the Czech Republic entered into an international agreement.

#### **IV. VALUATION AND LTV CRITERIA**

Only the issuer's receivables arising from mortgage loans or parts thereof may be used for the proper coverage of the total obligations arising from all the mortgage bonds in circulation issued by one issuer. Such receivables or parts thereof may not, during the period when they are used for such coverage, exceed 70% of the aggregate mortgage lending value of the mortgaged property securing such receivables (70% portfolio LTV limit).

If any mortgage rights in priority sequence are attached at the same time to any real estate that serves to secure the construction savings credit or the cooperative housing construction loan, only the receivable from the mortgage loan or its part in the maximum amount of the difference between 70% of the mortgage lending value of the real estate under mortgage and the sum of the receivables from the loan extended by the building society and the cooperative housing construction credit may be used for the purposes of coverage of the MCBs.

The issuer of the MCBs determines the *mortgage lending value* of the real estate under mortgage, and namely as the *prudent market value*, taking into consideration:

- > The permanent and long-term sustainable characteristics of the real estate under mortgage;
- > The revenues attainable by a third party at regular management of the real estate;
- > The rights and defects associated with the real estate; and
- > The local real estate market conditions and impacts and presumed development of this market.

The *prudent market value* is considered to be such price that could be achieved in the event of the sale of the same or similar real estate as at the valuation date and in dependence on its condition and quality. The *prudent market value* should not reflect the extraordinary market circumstances, the personal relations between the participants and the subjective assessment of the interest of one of the parties. The *mortgage lending value* shall not exceed the *prudent market value* of the real estates.

The conditions allowing the use of the receivable from the ML to cover the MCBs have to be complied with throughout the period for which the receivable from the ML is included in the MCB coverage.

In June 2016, the Czech National Bank issued a decree recommending the banks to limit granting of mortgage loans with high LTV. According to that, since April 2017, banks should not have any mortgage loans with LTV exceeding 90%, and loans with LTV between 80% and 90% should not constitute more than 15% of the volume of newly granted loans.

In December 2016, the Mortgage Credit Directive was transposed into Czech law with the aim to harmonise underwriting processes and information requirements towards customers.

## **V. ASSET – LIABILITY MANAGEMENT**

The sum of all the liabilities from all the MCBs in circulation issued by one issuer has to be fully covered with the receivables or their parts from the ML (regular coverage) or possibly in a substitutive manner (substitutive coverage). No other test is required by the law. Derivatives are not eligible cover assets.

## **VI. COVER POOL MONITORING AND BANKING SUPERVISION**

The issuer of the MCBs is obligated to keep separate and conclusive records on the summary of all of its liabilities from the MCBs in circulation issued by it and on its coverage. The content of the records is defined in an obligatory regulation by the CNB (Czech National Bank). Pursuant to this regulation, the issuer of the MCBs shall keep the Coverage Register and the Coverage Ledger.

The Coverage Register contains a summary of how the liabilities of the issuer of MCBs are covered – with both the regular coverage (i.e. the list of the receivables from the MLs used to cover the MCBs) and with the substitute collateral, if applicable. The records in the Coverage Register shall be updated by the issuer continuously as the changes occur.

The Coverage Ledger contains the full summary of the liabilities of the issuer from its MCBs in circulation and the valuation of the assets of the Coverage Register.

The records shall be kept in CZK in paper form or in electronic form. The recordkeeping including the insertion of the MLs for coverage and elimination of the MLs from the coverage shall be made by the departments independent of the departments responsible both for the extension of MLs and for issuance of the MCBs and namely up to the managing Board member.

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

In the event of bankruptcy or bankruptcy proceedings of the issuer of the MCBs, the receivables from the MCBs in circulation issued by it have a priority rank for satisfaction. The assets (the receivables from the ML) serving to cover the MCBs of the bankrupt issuer constitute the mortgage estate (cover pool). A special administrator may be appointed to administer the mortgage estate and to satisfy the claims resulting from the MCBs in circulation. The yield from the encashment of the mortgage estate shall be first used to satisfy the costs of administration and encashment of the mortgage estate and then immediately to satisfy the receivables of the MCBs without limitation of their amount. Only the rest shall be used to satisfy the other receivables from the bankrupt issuer. Otherwise there is no specific provision regarding the treatment of cash flows generally, including those received prior to opening of the insolvency proceedings or declaration of bankruptcy and those

received afterwards. The current automatic acceleration of covered bonds is intended to be removed in the planned update of the legal framework for Czech covered bonds.

### **VIII. 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 (CRR)<sup>1</sup>.

The risk-weighting of MCBs is regulated by the Czech National Bank decree no. 123/2007 Coll. transposing EU's Capital Requirements Directive into the Czech law. Risk-weight of 10% (under the standardised approach) is assigned provided that the MCB complies with the requirements of the Annex 4 of the aforementioned decree.

Czech investment legislation allows investment funds to invest up to 25% of the fund's assets in MCBs complying with the requirements of Article 52(4) UCITS Directive (Art. 28(2)(c) of the Czech Collective Investment Act).

### **IX. ADDITIONAL INFORMATION**

#### **State Incentives**

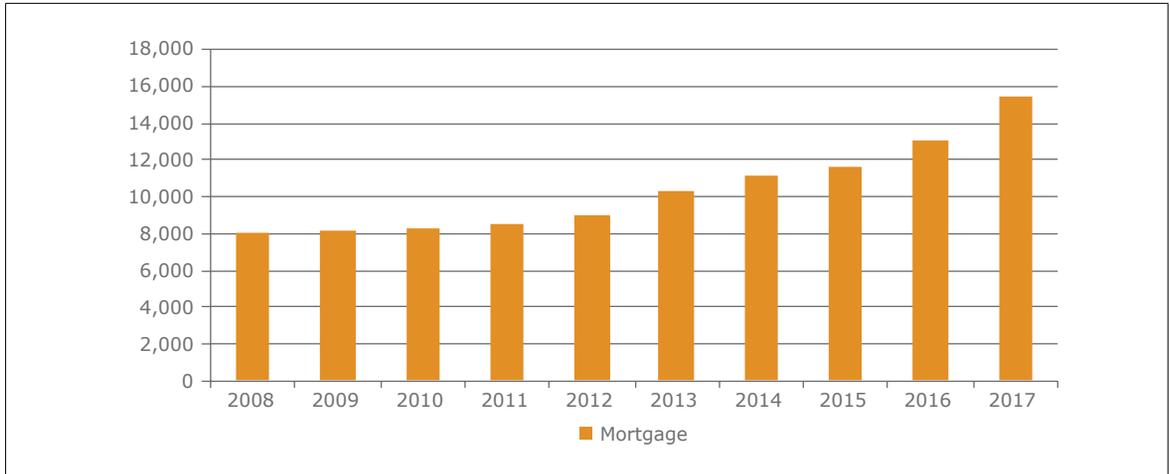
The debtor from the ML may reduce his income tax base with the interests he has paid to the issuer from the ML used to finance his housing needs.

The interest revenues from MCBs are exempt from the income tax, provided that such MCBs were issued before 1 January 2008 and are covered by receivables from MLs for housing investments.

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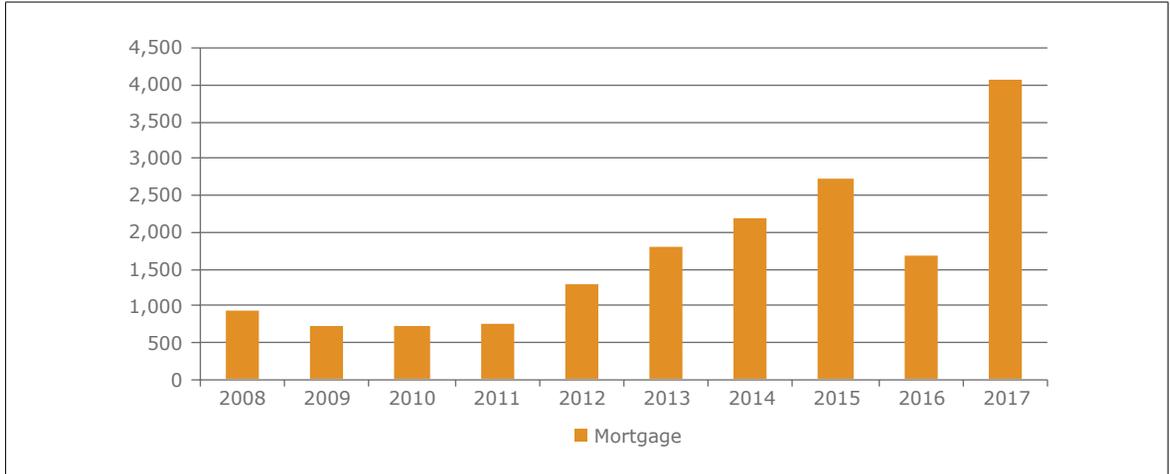
<sup>1</sup> Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): <https://hypo.org/ecbc/covered-bonds/>.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2008-2017, EUR M



Source: EMF-ECBC

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



Source: EMF-ECBC

**Issuers:** Česká spořitelna, Československá obchodní banka, Hypoteční banka, Komerční banka, Raiffeisenbank, Sberbank CZ, Wüstenrot hypoteční banka, UniCredit Bank Czech Republic and Slovakia.

**ECBC Covered Bond Comparative Database:** [http://www.ecbc.eu/framework/112/Czech\\_Republic\\_Covered\\_Bonds](http://www.ecbc.eu/framework/112/Czech_Republic_Covered_Bonds).