

## **3.25 SLOVAK REPUBLIC**

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### **I. FRAMEWORK**

According to §§14-17 of the Act on Bonds, a mortgage bond, or Hypotekárny Záložný List (HZL) in Slovak, is a bond which both in terms of face value as well as in terms of interest payment is guaranteed by a claim against a bank (§ 16 Subsection 4) or a branch of a foreign bank as well as by mortgage loans secured by a pledge on real estate or through a substitute coverage (collateral) (§ 16 Subsection 5). In order to become a mortgage bond issuing institution, the respective bank has to apply for a license. The minimum amount of cash contribution to the bank's equity capital necessary to establish a mortgage bond issuing institution is SKK 1,000,000,000 (EUR 33 mn) or an equivalent amount in fully convertible foreign currency, which is twice the amount necessary to establish a non-mortgage bond issuing bank. Furthermore, the license application has to contain details on the minimum requirements, as outlined in Section II.:

#### Article 16

(4) The total par value of issued mortgage bonds must be covered at least in the same amount and at least with the same yield as the par value of the mortgage bank's receivables from mortgage loans, and this shall represent due (ordinary) coverage.

(5) Due coverage of issued mortgage bonds may be replaced by substitute coverage at most up to the level of 10% of the total par value of issued mortgage bonds.

- > the methods of keeping a mortgage register;
- > the proposal for appointment of the mortgage controller (trustee) and his/her deputy;
- > the real estate assessment methods (valuation); and
- > the method of keeping a separate analytical record of mortgage activities within the bank's accounting system.

As the criteria indicated in the criteria above, in order to be distinguishable from the insolvency estate of the bank, the mortgage loans serving as due (ordinary) coverage for mortgage covered bonds, just as all other items serving as substitute collateral, have to be recorded in separate mortgage (coverage) register by the issuing bank.

With respect to the general approach to covered bonds the model, applied by Slovakian lawmakers is similar to common practice in Germany and Spain.

However, what is significantly different is the introductory period. In order to allow for a smooth start of the covered bond business after a covered bond issuing license has been granted, the Slovakian covered bond law defines the conception of temporary mortgage bonds.

Within eighteen months following the effective date of mortgage business license, a bank may issue, upon a decision taken by its general meeting, temporary mortgage bonds in form of bearer securities with a total nominal value not exceeding 50% of the bank's basic capital. The bank is obliged to exchange

<sup>1</sup> The term mortgage trustee can be used interchangeably with cover pool monitor or mortgage controller.

such temporary mortgage bonds for mortgage bonds covered in accordance with § 16 Subsections 4 and 5 (full collateralisation including maximum share of substitute collateral) of the covered bond law within two years of issue thereof. The provisions of the covered bond law shall not apply in time from issue of temporary mortgage bonds until their exchange for mortgage bonds covered in accordance with the above mentioned paragraphs.

Should a bank fail to exchange the temporary mortgage bonds for mortgage bonds covered within two years following issue of relevant temporary mortgage bonds, the bank is obliged to repay such temporary mortgage bonds in their nominal value including yields for the period from issue until repayment. In practise the conception of temporary mortgage bonds has not been realised up to now.

Another specialty of Slovakian Covered Bonds lies in the fact that a covered bond issued by a specific institution terminates automatically when bought back by the issuer. Hence, activities like market making in own issues or minor price nursing is very restricted. Certainly, this is not an issue for the time being as Slovakian Covered Bonds are not heavily traded products. However, this might become an issue in the future when the euro will be the dominating predominant currency and bonds might be placed more with international investors.

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

The mortgage bonds issuers are universal credit institutions. In accordance with Act on Banks, No. 483/2001, amendments, and with relevant decree the minimum requirements to obtain and keep the special licence are as follows:

- > the minimum amount of cash contribution to the bank equity capital, is SKK 1,000,000,000 (EUR 33,193,919) or an equivalent amount in fully convertible foreign currency;
- > the methods of keeping a mortgage register;
- > the proposal for appointment of the mortgage supervisor (trustee) and his/her deputy;
- > the real estate assessment methods (valuation); and
- > the method of keeping a separate analytical record of mortgage activities within the bank's accounting system.

Basic principles (rules, limits) of mortgage transactions are included in Part Twelve Mortgage Banking, Articles 67 – 88.

The issuer holds the cover assets on his balance sheet. A subsequent transfer of the cover assets to another legal entity does not take place. Given that a direct legal link between single cover assets and Hypotekárny záložný list (HZL) does not exist, all obligations relating to HZL are obligations of the issuing bank as a whole, to be paid from all the cover assets of the issuer.

## **III. COVER ASSETS**

Slovak covered bonds benefit from coverage in the form of original collateral as well as substitute collateral. The latter must not exceed 10% of the total nominal value of mortgage bonds issued. The definition of ordinary collateral is based on the definition of mortgage loans stipulated in Art. 68 of the Slovak Banking Act Nr 483/2001. According to this article, a mortgage loan is defined as a loan with a maturity of at least four years and a maximum of thirty years, secured by the right of lien established upon a domestic real estate, (including on an uncompleted unfinished construction, which is at least to

the amount of 90% complete), **unless this Act requests otherwise**, financed by the issue and sale of mortgage bonds by a mortgage bank pursuant to the Slovak covered bond regulation. *The National Bank of Slovakia may, by its decision issued on the basis of an application of mortgage bank for reasons worthy of special attention maximum for a maximum period of two years stipulate special conditions for financing of mortgage and municipal loans, at least 70 %, even repeatedly. A reason worthy of special attention is in particular an attempt to maintain the stability of the financial sector.*

The loan in question is supposed to finance one of the following items:

- > acquisition of domestic real estate or any part thereof;
- > construction or modification of existing structures;
- > maintenance of domestic real estate; or
- > repayment of an outstanding loan drawn for purposes above;
- > repayment of an outstanding loan drawn for purposes mentioned above.

In order to be eligible for collateral (coverage) purposes, the LTV of a mortgage loan is capped at 70%. A bank may grant loans also above this limit, however, the total amount of loans with LTV ratios larger than 70% are capped at 10% of the total amount of mortgage loans granted by the bank. These mortgage loans do not serve as mortgage bonds coverage, and therefore, the part above 70 % reduces relevant cover pool. A mortgage loan may not be secured by a lien on the real estate, on which a lien has already been established and continues in favour of a third party. As already indicated, substitute collateral may be used up to a share of 10% of the total nominal value of issued covered bonds. The following property values belonging to the mortgage bank may be used for the substitute coverage:

- > deposits in the National Bank of Slovakia;
- > National Bank of Slovakia bills;
- > deposits in banks with registered offices in the Slovak Republic;
- > deposits in branches of foreign banks in the Slovak Republic;
- > cash;
- > treasury bonds;
- > treasury bills; and
- > covered bonds issued by another bank;

It is important to note that neither ABS nor derivatives qualify for the cover pool.

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

Property valuation is regulated in the Act on Banks, Article 73: (1) For the purposes of this Act, the value of real estate shall be determined by a mortgage bank on the basis of an overall assessment of the real estate concerned. In determining the value, the mortgage bank may only take into account permanent features of the real estate and benefits that can be derived by the owner from the real estate in the long run. For real estate burdened by a lien or transfer restrictions in accordance with Article 74, paragraph 2, a mortgage bank shall lower the value of the real estate by the amount of claims guaranteed by such lien or transfer restrictions. Article 73 (2) A mortgage bank shall only be bound by its own valuation of real estate.

Monitoring requirements result from the Decree of the National Bank of Slovakia of 13 March 2007 on banks' own funds of financing and banks' capital requirements and on securities dealers' own funds of financing and securities dealers' capital requirements, Article 110, letter a) – d):

a) legal certainty exists, meaning that the bank's right arising under an agreement on establishing a lien or under an agreement on pledging a right or assigning a receivable is enforceable in all jurisdictions relevant in regard to the collateralising and payment function of the respective credit protection;

b) the property values are monitored, meaning that the value of the property is monitored on a sufficiently frequent basis and at a minimum once every three years for residential real estate. More frequent monitoring is carried out where the market is subject to significant changes in market conditions. Statistical methods may be used to monitor the value of the property and to identify property that needs revaluation. The property valuation shall be reviewed by an independent valuer when information indicates that the value of the property may have declined materially relative to general market prices. For loans exceeding EUR 3 million or 5% of the own funds of the bank, the property valuation shall be reviewed by an independent valuer at least every three years.

c) the types of residential real estate accepted by the bank under its lending policy are documented;

d) procedures are in place to monitor that the property taken as collateral (or the object of a pledged right) is adequately insured against damage.

For both commercial and residential property, the LTV limit is 70% of the mortgage lending value of the property. This LTV is a relative limit, i.e. when the loan exceeds the 70% limit, the part of the loan up to 70% LTV remains eligible for the cover pool. Over this limit a bank may grant mortgage loans exclusively if their total value does not exceed 10% of the total amount of mortgage loans granted by the bank.

## **V. ASSET-LIABILITY MANAGEMENT**

Article 16 (4) of the Act on Bonds stipulates that the total volume of HZL outstanding must be covered at all times by assets of at least the same amount and with at least the same interest income. Thus, the nominal value of the cover assets must permanently be higher than the respective total value of the HZL and the interest yield must be at least the same.

Cash flow mismatch between cover assets and cover bonds is furthermore reduced by the prepayment rules applicable to fixed interest rate mortgage loans. Prepayments of mortgages during fixed rate periods are only permitted in cases of 'legitimate interest' of the borrower or after a period of the fixation term. (This is a part of loan agreement). If the mortgage is prepaid, the borrower has to compensate the damage of the lender caused by the prepayment.

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

A cover pool monitor (mortgage trustee, mortgage controller) supervises the cover pool. He/she is appointed by the National Bank of Slovakia (central bank) and must possess the expertise and experience necessary to fulfil all duties. A mortgage controller or his deputy may only be a natural person who has the necessary professional competence and integrity to carry out this activity. A natural person with completed university education, who has at least five years experience in economics or law in the banking sector, shall be deemed professionally competent. A person shall be deemed to have the necessary integrity if he has not been lawfully sentenced for a criminal offence committed in the discharge of a management office or any intentional criminal offence.

## Article 80, Act on Banks

(1) A mortgage controller shall supervise the issuance of mortgage bonds and municipal bonds with regard to their particulars and coverage pursuant to a separate regulation.

(2) Prior to each issue of mortgage bonds or municipal bonds, a mortgage controller shall be obligated to issue a written certificate testifying that they are covered in accordance with a separate regulation, and that an entry was made in the register of mortgages.

(3) A mortgage controller shall check whether a mortgage bank provides mortgage and municipal loans, including their securing through mortgage and whether a mortgage bank meets its obligations in respect of the mortgage register in accordance with this Act and other generally binding regulations.

(4) If requested by a mortgage bank, a mortgage controller shall be obligated to assist in activities related to the performance of mortgage operations, which could not be completed by the mortgage bank without his assistance.

### **How are segregation of cover assets and bankruptcy remoteness of covered bonds regulated?**

A cover register permits the identification of the cover assets. The register records the cover assets being used to cover HZL. A list of mortgage and municipal loans and their amounts, liens and claims of a mortgage bank under mortgage and municipal loans that serve to cover mortgage and municipal bonds, or other assets serving as substitute coverage, must be kept separately by a mortgage bank in its *register of mortgages* (Article 76 paragraph 1, Banking Act). The register of mortgages and the documents on the basis of which the entries have been made in the register of mortgages must be kept by a mortgage bank separately from other documents and protected against misuse, destruction, damage or loss (Article 76 paragraph 2, Banking Act). By the end of January and July of each calendar year, a mortgage bank shall be obligated to notify the National Bank of Slovakia and the Ministry of all entries made in the register of mortgages in the last six months (Article 76 paragraph 3, Banking Act). The due form and method for keeping the register of mortgages pursuant to paragraph 2 and the due form of information disclosed pursuant to paragraph 3 shall be determined in detail by the National Bank of Slovakia and the Ministry of Finance by means of a generally applicable regulation (Decree No. 661/2004 Coll. on mortgages register and details over position and activities of a mortgage trustee (supervisor)).

### **Asset segregation**

The cover pool is a part of the general estate of the bank as long as the issuer is solvent. If insolvency proceedings are launched, the assets recorded in the cover registers are governed by the Act No 7/2005 Coll. on bankruptcy (§8, §§ 28 (2), § 50, § 67), also § 72 (3) of Act on banks. See also preferential treatment of covered bond holders.

### **Impact of insolvency proceedings on covered bonds**

Covered bonds do not automatically accelerate when the issuing institution is insolvent, but will be repaid at the time of their contractual maturity.

### **Preferential treatment of covered bond holders**

Privilege right of mortgage (municipal) bonds owner is specified explicitly in the Slovak relevant acts:

*"Mortgage (municipal) bonds owners shall have pre-emptive security right to assets used to secure issued mortgage (municipal) bonds, including the right of lien to real estate pursuant to Act on banks (Article 74); this security right in procedure according to Act on banks, No. 483/2001 Coll., or separate regulations - for instance, Article 8, Article 28 par. 2, Articles 69 and 176 to 196 of Act No. 7/2005 Coll. on bankruptcy as amended – shall secure secured receivables of mortgage (municipal) bonds owners against the mortgage bank for the payment of the nominal value and yields upon mortgage (municipal) bonds".*

### **VII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION**

Slovak "Hypotekárny záložný list" fully comply with the requirements of Art. 52 par. 4 UCITS Directive.

#### **Article 45 (7) and (11) of Collective Investment Act**

(7) The value of bonds issued by a single bank, or by a foreign bank in a Member State which is subject to supervision that protects the interests of bondholders, may not constitute more than 25% of the value of an open-end fund's assets. Funds raised by the issue of bonds shall be invested in such assets which, until the maturity of the bonds, cover the issuer's liabilities related to the bond issue and which may, in the event that the issuer becomes insolvent, be used to redeem the nominal value of the bonds and to pay the income on them. The aggregate value of bonds acquired for an open-end fund's assets under the first sentence may not exceed 80% of the value of the open-end fund's assets.

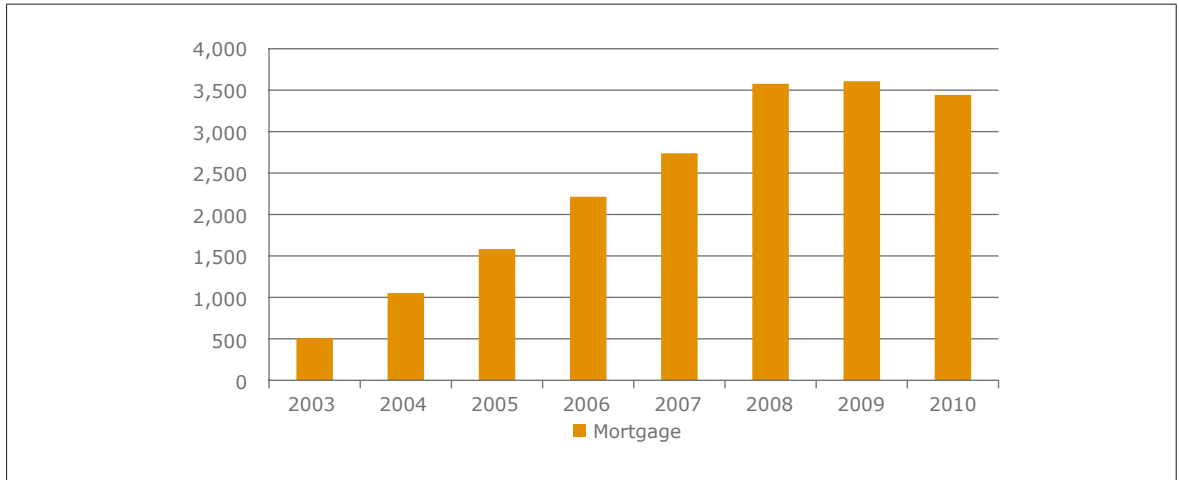
(11) Bonds which are issued in the Slovak Republic and meet the criteria laid down in paragraph (7) shall be deemed to include **mortgage bonds** and **municipal bonds** (municipal debt) issued by a bank which, with the funds raised from their sale, provides a municipal loan to a municipality or higher territorial fund share, and provided that these municipal bonds are guaranteed in accordance with the conditions stipulated by a separate law (Act on Bonds).

In regard to the bonds mentioned in paragraph (7) that are issued in a Member State, the management company shall take into account the similar list of bonds compiled in accordance with the law of this Member State, provided that such a list exists.

Finally, Slovak institutional investors investment legislation allows:

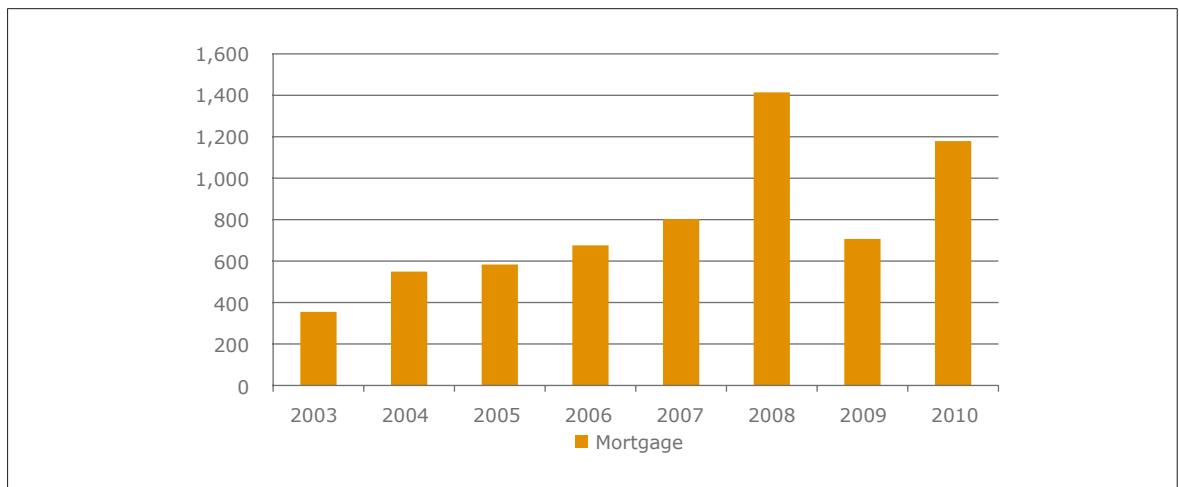
- > mutual funds to invest up to 25% of their assets in HZL;
- > insurance companies up to 20 % of their technical reserves in HZL; and,
- > pension funds up to 15 % of their assets in HZL.

> Figure 1: Covered Bonds Outstanding, 2003-2010, EUR m



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2010, EUR M



Source: EMF/ECBC

**Issuers:** There were eight issuers in Slovakia as of the end of 2010: CSOB, Dexia Banka, Istrobanka, Volksbank, OTP Banka Slovensko, Slovenská sporiteľna, Tatra Banka, UniCredit Bank (Slovakia) and Všeobecná úverová Banka.