3.26 POLAND

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I. FRAMEWORK

The legal framework for covered bonds (Listy Zastawne, also LZ) is mainly determined by:

> The Act on Covered Bonds and Mortgage Banks (*Ustawa o listach zastawnych i bankach hipotecznych*) of August 29, 1997; (The List Zastawny Act – hereafter: The LZ Act).

> The Bankruptcy Law (*Prawo upadłościowe*) of February 28, 2003, Chapter II – Bankruptcy proceedings for mortgage banks, Article 442–450.

In 2014, key under-law regulations for mortgage banks were amended:

> Recommendation F – the standards for determining mortgage-lending value were ease.

> Recommendation K – the rules on keeping and managing cover registers were actualised.

Both recommendations were to be implemented by 1 January 2015.

In 2015 the LZ Act has been thoroughly updated in order to increase the safety of the covered bonds and their availability to investors with new provisions coming into force as of 1 January 2016. Among the key modifications were: introduction of statutory overcollateralisation and liquidity buffer, and increase of funding limit for residential loans as well as implementation of soft bullet and conditional pass through structure upon insolvency.

In 2015, new *Regulation of the Minister of Finance of 30 December 2015 on conducting the collateralisation review and coverage and liquidity tests* was issued.

Additionally, in 2015, further amendments were introduced to Recommendation K.

II. STRUCTURE OF THE ISSUER

The issuer is a specialised credit institution (mortgage bank) with the supervision of Polish Financial Supervision Authority (*Komisja Nadzoru Finansowego*, KNF). It is required by law that the mortgage bank is a joint stock company with a legal personality (not a branch) with two licences: a banking licence and consent to start operating activity, both granted by the KNF.

The additional covered bond issuer is Poland's only state-owned bank, Bank Gospodarstwa Krajowego (BGK), which may issue covered bonds to finance in particular government programmes. However, there have been no issues of BGK so far.

According to the LZ Act, a mortgage bank is limited in its range of business activities, i.e. it may only engage in activities specified in a closed catalogue. The operations of a mortgage bank can be divided into two groups: core and non-core, and may be also executed in foreign currencies.

The core operations which may be performed by mortgage banks include:

> Granting loans secured with mortgages;

> Granting loans where the borrower, guarantor or underwriter of a loan repayment is the National Bank of Poland, European Central Bank (ECB), governments or central banks of the European Union (EU) member states, Organisation for Economic Cooperation and Development (OECD), or where a guarantee or security is granted by the State Treasury;

> Acquisition of other banks' receivables on account of loans granted by them;

> Issuing mortgage covered bonds;

> Issuing public sector covered bonds.

Apart from core operations, mortgage bank's approved activities comprise: taking credits and loans, issuing bonds, securities safekeeping, providing consulting and advice with respect to the property market, managing receivables of a mortgage bank and other banks arising from mortgage-backed loans, as well as granting such loans on behalf of other banks on the basis of relevant cooperation agreements.

A mortgage bank is not authorised to perform any other activities apart from the operations listed above. Particularly, it cannot accept deposits. Such limitations facilitate maintaining a more simplified and clear activity structure and the specialisation of the loan division as well as the improvement of credit risk assessment methods in the field of real estate financing. Furthermore, funds obtained from covered bond issues shall be used mainly for funding the lending activity of a mortgage bank.

III. COVER ASSETS

Mortgage banks in Poland focus on mortgage or public sector lending. The loans are held on the balance sheet of the issuer and registered in two separate cover registers, which form two separate cover pools.

There are two specific classes of covered bonds which correspond to each of the cover assets:

> hipoteczne listy zastawne (mortgage covered bonds) and

> publiczne listy zastawne (public sector covered bonds).

Both mortgage and public sector covered bonds are direct and unconditional obligations of the issuer and must be fully secured by cover assets of the respective class. Upon the issuer's default, covered bondholders have a dual recourse to a segregated cover pool of assets and, if the cover pool proves to be not sufficient, an unsecured claim against the issuer. Furthermore, the covered bondholders benefit from a statutory priority claim over all the assets in the cover pool. There is no time subordination: all covered bonds are ranked *pari passu*.

Pursuant to the LZ Act, the substitution assets can be included in the cover pool i.e. they may consist of the bank's funds invested in the securities issued or guaranteed by the National Bank of Poland, ECB, governments or central banks of the EU Member States, OECD (with the exclusion of states which are, or were, restructuring their foreign debt in the last 5 years), and the State Treasury, deposited at the National Bank of Poland or kept in cash. However, the total nominal amounts of the mortgage bank's claims secured with a mortgage or based on the public sector claims, constituting a basis for the issue of mortgage covered bonds, may not be less than 85% of the total amount of nominal value of outstanding covered bonds.

All hedging derivatives are eligible for the cover pool (the bank can conclude only hedging derivatives). Settlement amounts due under such contracts and included into the cover pool rank *pari passu* with claims of covered bondholders.

In addition, receivables secured by mortgages established on buildings, which are in the construction process, may not in total exceed 10% of the overall value of mortgage-secured receivables in the cover pool. Within this limit, the receivables secured by mortgages on construction lots in compliance with the land-use plan may not exceed 10%.

IV. VALUATION AND LTV CRITERIA

The property valuation in a mortgage bank is conducted under the rules stipulated in the LZ Act. According to the Polish covered bond legislation, establishing the mortgage lending value of the property shall be performed with due care and diligence on the basis of an expert's opinion. It shall be prepared by the mortgage bank or other entities with appropriate real estate appraisal qualifications commissioned by the mortgage bank. The mortgage lending value cannot be higher than the market value of the property.

Apart from the assumptions laid down in the LZ Act concerning property valuation in a mortgage bank, there are special banking supervisory regulations (Recommendation F), which stipulate in detail the establishment of the mortgage lending value and impose a duty on a bank to have a database for real estate prices.

The funding limit – related to a single loan – is established at the level of 60% of the mortgage lending value of the commercial property and of 80% in the case of residential property (Article 14 LZ Act). In the part above 60% of the mortgage lending value of the property, the total amount of receivables from granting credits secured with mortgages or receivables purchased from other banks arising from their mortgage-secured credits, may not exceed 30% of the total amount of the mortgage bank's receivables secured with mortgages (absolute portfolio limit, Article 13.1 LZ Act).

Apart from funding limit, there is also lending limit, according to Article 13.2 LZ Act, stipulating that single loan granted or purchased by a mortgage bank cannot exceed the mortgage lending value of the property.

V. ASSET-LIABILITY MANAGEMENT

According the LZ Act (Article 18), the total nominal value of all outstanding covered bonds (which should be calculated separately for each class) shall not exceed the sum of nominal amounts of (either mortgage or public sector) covered assets, which form the basis for the covered bond issue. Since January 2016, the on-going cover principle is more prudent, including 10% mandatory overcollaterisation. That would apply to both public and mortgage covered bonds, the overcollaterisation is calculated on nominal basis regarding the capital amount of outstanding covered bonds. Additionally, part of the cover pool would be compulsory composed of liquid assets (e.g. central bank eligible bonds), in order to ensure preparation of liquidity buffer, not being a base for the covered bond issue. It is assumed that the value of these liquid assets (liquidity buffer) would ensure full and timely payment of the interest on the covered bond due in the upcoming 6 months.

Thus, the nominal value of respective covered assets shall permanently be higher than the total nominal value of the respective covered bonds. In addition, the mortgage bank's income from interest on its respective cover assets may not be lower than the amount of bank's payable interest on its respective outstanding covered bonds.

VI. TRANSPARENCY

Cover pool transparency reports for individual banks are available at their respective websites (see below). Two out of three Polish mortgage banks are holding the Covered Bond Label and publish their reports following Harmonized Transparency Template.

The majority of Polish covered bonds (public sector and mortgage covered bonds, the latter denominated in PLN as well as in EUR) are listed on the Catalyst, a local bond market operated by WSE and BondSpot. Covered bonds denominated in EUR are also listed on the Luxembourg Stock Exchange.

Both markets are supervised by the Polish Financial Services Authority and are approved as regulated markets by the European Securities and Markets Authority (http://registers.esma.europa.eu/publication/searchRegister?core=esma_registers_mifid_rma).

Issuers, whose securities are listed on the regulated market, are legally bound to provide actual and potential investors with all and any information about their company's economic situation and events which may have an effect on investment risk. Consequently, mortgage banks are obliged to submit disclosures in the form of current and periodic reports, including information on subscription, assigned rating or interest payment dates of covered bonds.

Issuance documents such as Base Prospectus and Supplements for individual series comprising detailed information on the covered bonds as well as the issuer can be found on the issuers' websites:
mBank Hipoteczny: http://mhipoteczny.pl/en/investor-relations/
Pekao Bank Hipoteczny: http://www.pekaobh.pl/
PKO BP Bank Hipoteczny: https://www.pkobh.pl/en/

VII. COVER POOL MONITOR AND BANKING SUPERVISION

One of the key features of Polish covered bond legislation (Article 31 LZ Act) is the monitoring role undertaken by the covered pool monitor (*powiernik*) who is appointed by KNF at the request of the mortgage bank's supervisory board. The cover pool monitor is independent and shall not be bound by instructions of the appointing body.

The cover pool monitor is responsible for an ongoing control of the appropriateness of the cover pool management. Its main tasks comprise monitoring of the cover pool (i.e. confirming the accuracy of the inclusion in or removal from the cover register of the cover assets, ensuring that the asset eligibility requirements are met, verifying the correctness of the value registered in the cover pool, etc.) as well as the issuer's compliance with specific provisions of the LZ Act and reporting any breaches of them to the KNF.

The cover pool monitor is required to perform above mentioned tasks not only on an ongoing basis, but also prior to every issuance of a mortgage bank in order to ensure that a mortgage bank provides an appropriate cover for the planned issue. The issuer is obliged to provide full cooperation to the cover pool monitor and shall give the cover pool monitor the right to review the register, loan documents, accounting books or other bank's documents at its request.

Apart from cover pool's management monitoring performed by the cover pool monitor, mortgage banks fall under the oversight of the KNF which carries out general assessment of Polish banks, including mortgage banks as a part of general banking supervision.

The KNF may commission an independent expert at the expense of the inspected mortgage bank to inspection of the appropriateness of the mortgage bank's entries to the mortgage cover register. This would also include establishing the mortgage lending value of the property was in compliance with the rules referred to in Article 22, paragraph 5 LZ Act.

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

Pursuant to the LZ Act and the Bankruptcy Law (which is complementary to the former in terms of the insolvency issues, containing a separate chapter: Chapter II – Bankruptcy proceedings for mortgage banks – Articles 442-450), in case of bankruptcy of a mortgage bank the receivables, claims and means entered in the cover register shall constitute a separate bankruptcy estate which may be used exclusively to satisfy claims of covered bondholders. Moreover, initiation of the insolvency proceedings does not affect *listy zastawne*, i.e. they do not automatically accelerate when the issuer becomes insolvent.

After declaring a bankruptcy of the mortgage bank, the court appoints the curator (*kurator*) who represents the rights of covered bondholders in the bankruptcy proceedings and notifies the total nominal value of outstanding covered bonds together with accrued interest to the bankruptcy estate. In order to perform these duties, the curator has the right to review the accounting books and other documents of the mortgage bank as well as to obtain all the necessary information from the receiver (*syndyk*), court supervisor (*nadzorca sądowy*) and administrator (*zarządca*).

The curator participates in the liquidation of a separate bankruptcy estate, performed by the receiver. If possible, the items of such estate may be sold to another mortgage bank. While maturities of covered bond principal are postponed automatically by 1 year further, during this period all interest payments are executed pursuant to the terms and conditions of the L.Z. The aim of that solution is to support the timely payment of covered bonds, if a mortgage bank goes insolvent. Additional amendments to the law on bankruptcy include the introduction of the asset coverage test, which verifies whether the separate insolvency estate is sufficient to fully satisfy the claims of the bondholders, as well as the liquidity test, which verifies whether the separate insolvency estate is sufficient to fully satisfy the claims of the covered bondholders on the extended redemption dates. These tests are conducted also during regular activity of the mortgage bank.

With a separate bankruptcy estate, the following categories should be satisfied successively:

> Liquidation costs of the separate bankruptcy estate, which also include the remuneration of the curator, as well as interest and other covered bonds receivables;

> Covered bonds as per their nominal value.

The Polish model, introduced in January 2016, stipulates a statutory soft-bullet-structure in case of a mortgage bank insolvency, conditional pass-through payments, as well as detailed regulated scenario for insolvency procedure with clear competences and precise legal tools for action including over-indebtedness and liquidity tests. Transition into both soft bullet and conditional pass-through structures can only be triggered by legally specified events (insolvency and failed coverage tests) with limited decision rights in this respect granted to covered bond holders (possible resolution of covered bondholders with 2/3 majority to sell the separate bankruptcy asset pool to another bank).

After satisfying the covered bondholders the surplus of the cover assets deriving from the separate estate shall be allocated to the general bankruptcy estate. In case that the separate bankruptcy estate does not fully satisfy the cover bondholders, the remaining amount shall be satisfied from the whole bankruptcy estate funds. In that case, the remaining amount shall be transferred from the bankruptcy estate funds to the separate bankruptcy estate funds. It indicates that the covered bondholders are given preference over other creditors.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

In order to apply a preferential risk-weighting for covered bonds, the instrument needs to meet the criteria laid down in the UCITS Directive and the CRR.

Polish covered bonds (*list zastawny*) already meet the criteria of Article 52(4) UCITS: in December 2008 list zastawny was notified by the European Commission (EC) as a European "eligible bond" (covered bond), i.e. the instrument with a qualified collateral and can be found on the EC's website at present (http://ec.europa.eu/finance/investment/legal_texts/index_en.htm).

Polish covered bonds also fall under the criteria of Article 129(1) of the CRR[1]:

> Substitution assets, including liquidity buffer, comply with Article 129(1)(a-b) CRR;

> Derivatives included in the cover pool may comply with Article 129(1)(c) CRR, at issuer's discretion depending of credit quality of chosen counterparty;

> Residential real estate loans comply with Article 129(1)(d) CRR, LTV limit of 80%

> Commercial real estate loans comply with Article 129(1)(f) CRR, LTV limit of 60%.

> Portfolio information is publicly available at least on semi-annual basis.

Following recent amendment of the LZ Act, foreign investors (both private and corporate) are exempt from withholding tax both in relation to coupons and principal amount.

PLN denominated *listy zastawne* are approved by the National Bank of Poland as the instruments eligible for intraday and lombard credit as well as repo transactions. As of May 2018, the haircut level for repo amounts to 18% for *listy zastawne* up to 7 years remaining to maturity. The haircuts for intraday and lombard credit are 13.5% – 25.5% (depending on maturity), same as for corporate and municipal debt.

EUR denominated *listy zastawne* issued under international covered bond programme are eligible for Eurosystem credit operations, but are not eligible for the CBPP.

1 For further information on the UCITS Directive and the Capital Requirements Regulation (CRR) please see: https://hypo.org/ecbc/covered-bonds/.

Polish investment regulations pertaining to investment limits for covered bonds are as follows:

> Banks – no statutory limits, internal concentration limits apply, high-quality liquid asset status depending on outstanding issue amount and rating;

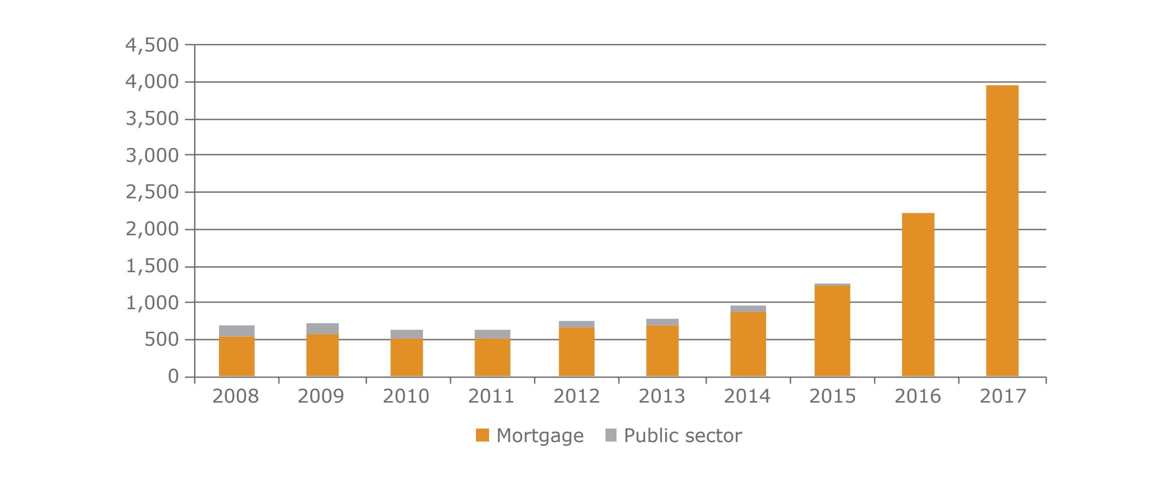
> Credit Unions – up to 8% of assets per issuer;

> Insurance companies – aggregate limit up to 40% (publicly traded) or up to 10% (not admitted to trading) of technical-insurance reserves;

> Investment funds – 25% of assets under management (AuM) limit for covered bonds per issuer or group, 35% of AuM limit for total exposure per mortgage bank or group (incl. deposits, unsecured debt and OTC derivatives), 80% of AuM limit for all covered bonds in portfolio;

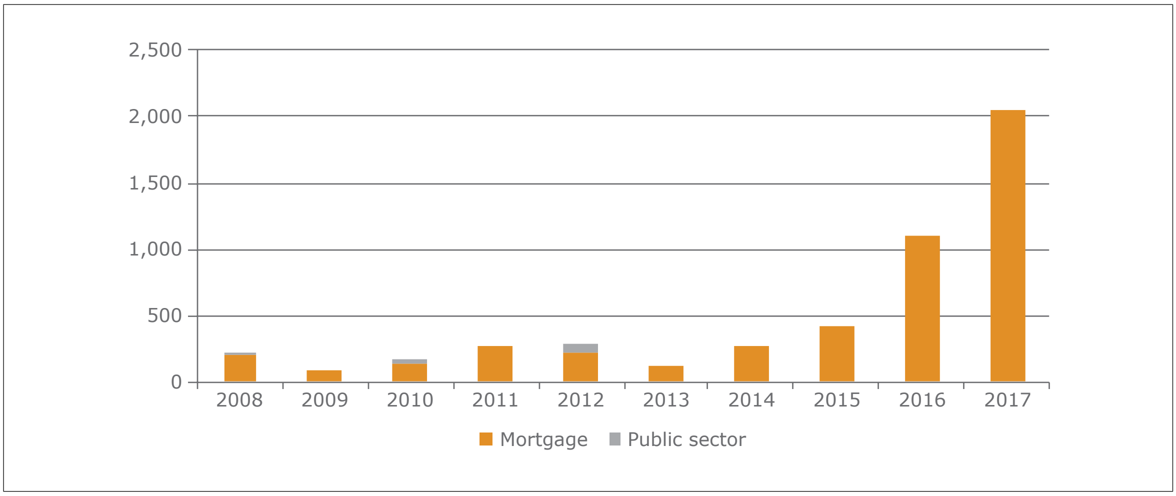
> Pension funds up to 40% of the total asset value, 5% per one issuer or issuer's group.

> 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: mBank Hipoteczny S.A., Pekao Bank Hipoteczny S.A. and PKO Bank Hipoteczny S.A.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/77/Polish_Covered_Bonds.

COVERED BOND LABEL : PKO Bank Hipoteczny Spółka Akcyjna (1 pool), mBank Hipoteczny S.A. (1 pool).