



A covered bond is a medium- to long-term maturity debt instrument. It is not a securitisation, although it is backed by assets, and has over 250 years' of history in Europe, importantly along with no record of default. Covered bonds are at the heart of the financial tradition of continental Europe, playing a central role in funding strategies and representing an efficient way of mortgage financing. They are characterised by the double protection (dual recourse) offered to their holders, the separation of collateralised assets in a cover pool that is dynamically managed, and strict regulatory and supervisory frameworks.

Before 2008 covered bonds were not a “sexy topic” for discussion. This was mostly due to their simplicity, which is now their biggest advantage. Following the 2008 financial crisis and the discredit it created for mortgage/asset-backed securities, the strategic importance of covered bonds as a long-term funding tool has been recognised globally. Covered bonds are playing an important role in the developed capital markets, contributing to the efficient allocation of capital and, ultimately, to economic development and recovery.

These benefits and developments could not go unnoticed by the authorities of the EBRD's countries of operations. Recognising the potential value of covered bonds for the local banking sector (so often reliant on parent funding) and the development of local capital markets, many EBRD countries started “talking” covered bonds. They have either introduced or are working on introducing and/or updating covered bond legislation. At this stage a new covered bond law has been adopted in Poland, Turkey and Romania, while countries such as Croatia are in the process of introducing the relevant legislation. While Hungary has introduced a requirement that 15 per cent of mortgage funding has to come through covered bonds.



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In this article we examine covered bond law in the EBRD's countries of operations with case studies from three EBRD jurisdictions: namely Poland, Romania and Croatia. Poland is an interesting case: it is a sizeable and relatively well-developed capital market but with no real covered bond market, mainly due to specialised mortgage banks being the only institution allowed to issue covered bonds. In Romania there has been no covered bond issuance since the covered bond law of 2006 was adopted – which is now being substantially amended to rectify the problems for interested issuers and potential investors. And Croatia is one of two EU countries that has no covered bond regime in place as yet.

DEFINING A COVERED BOND

A covered bond is primarily an on-balance sheet debt security issued by a bank. A covered bond's defining feature is the dual nature of protection (dual recourse) offered to investors with a special pool of assets used as collateral for the repayment of bonds. Assets that can be pooled to form collateral are defined in national law (definitions typically follow a list of eligible assets in the Capital Requirements Regulation specifying covered bonds that are eligible for preferential capital weightings for EU banks) and subject to direct and specific supervision to protect the interests of covered bonds bondholders. The assets that typically serve as cover include mortgages and public sector loans. Other assets have been considered for inclusion, for example: Turkish legislation provides for covered bonds being backed by small and medium-sized enterprise (SME) loans. However, the European Banking Authority (EBA) and the European Covered Bond Council believe that covered bonds are to be backed by either mortgages or public sector loans

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CHART 1 COUNTRIES WITH COVERED BONDS LEGISLATION



so as not to degrade the value of the covered bond brand. This is to be either confirmed, or revisited, in the course of work on the EU Capital Markets Union.²

It is worth emphasising that covered bonds are far from being an exotic financial instrument, and, in the normal course of business, from the bondholder's point of view, are not significantly different from any other secured or unsecured bond issued by a credit institution. The issuer pays interest and principal to the bondholders in the same manner as for other secured or unsecured bonds.

A common misunderstanding, typical for jurisdictions where a covered bonds legislation or market has not yet been developed, is confusing covered bonds with various other securitisation structures. While the structure of both types of instruments can in certain cases be quite similar (for example if a special purpose vehicle or SPV is used to create and segregate a cover pool of, for example, mortgage loans and to issue bonds) the similarity stops at the structure level and differences start appearing when analysing the rights and duties of issuers and investors.

Unlike a securitised bond a covered bond is an on-balance sheet obligation of the issuer enhanced by a specific collateral (cover pool) created in favour of the bondholders. In a covered bond structure, the creation of a pool of assets and its segregation from the insolvent estate of the issuer is for the sole purpose of providing security to the investors in case of issuer insolvency; while in a securitisation structure it is to transfer risk away from the issuer (by removing it permanently from the issuer's balance sheet). Covered bonds are also "full recourse" instruments meaning that if after the activation of the collateral cover pool (in the case of issuer's bankruptcy) the pool gets depleted before the bonds are fully repaid, the bondholders, for the residual (remaining) value, come in *pari passu* status with other general creditors of the bankrupt issuer, while in a typical securitisation that would not be the case as no recourse to the originator would be possible in such a case.

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ADVANTAGES COVERED BONDS BRING TO A TRANSITION ECONOMY

Covered bonds can potentially provide several key benefits to a transition economy. By allowing banks to fund longer-term assets in a way which is cost effective, more accurately matched to the term of those assets (thus removing balance sheet gap risks), and relatively delinked from their own credit rating (which allows market access at times of systemic stress), covered bonds contribute to the stability of the banking system. This is particularly the case in the EBRD region where banks so often rely on funding from a parent, either an Italian or German bank. The Vienna II Initiative advocates for such reliance to be decreased, and local funding sources explored.

Due to the fact that covered bonds can be secured on a portfolio of high-quality mortgage assets, usually with an 80 per cent loan-to-value (LTV) ratio, and subject to strict quality controls, they can contribute to an improvement in loan origination processes. They do not allow the originator to pass on any credit risk to a third party and therefore encourage sustainable, responsible lending practices. Many domestic classes of investors such as insurance companies and pension funds can sometimes be heavily exposed to a relatively

narrow set of fixed-income assets, and covered bonds can offer them a viable, stable, liquid and long-term alternative for the diversification of both their credit and liquidity risks.

Covered bonds can also be a cost-effective source of foreign investment by allowing local banks to attract foreign investment at a lower cost and potentially in higher quantities than any other form of fund raising. In addition to the facilitation of foreign investment, when local banks fund domestically they inevitably facilitate the development of a liquid and high-quality, local capital market.

LEGAL FRAMEWORK FOR COVERED BONDS IN EUROPE

Covered bonds are structured according to national laws. EU law does not provide for a comprehensive framework for the issuance of covered bonds. Instead, the EU law sets certain criteria (primarily in the Capital Requirements Regulation – Article 129), and enables the covered bonds investors to benefit from preferential capital treatment when investing in cover bonds that satisfy those criteria.³

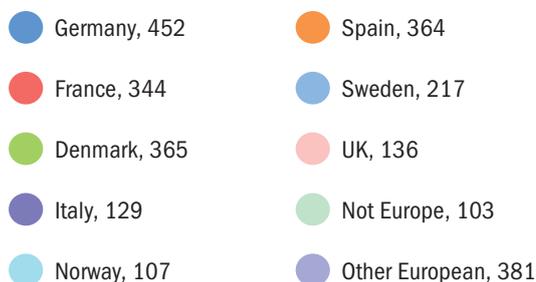
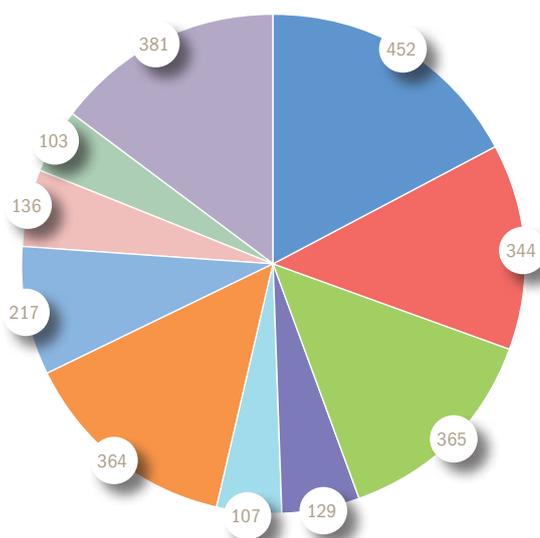
In September 2015 the European Commission published a consultation paper discussing the possibility of an EU-wide covered bond law as part of the Capital Markets Union initiative. However national specificities throughout the European Union make it highly unlikely that such a law could be promulgated in the medium term, if ever.

This is because covered bonds are so variously regulated throughout the EU and costs created by legal uncertainty and changing market practices would probably outweigh the benefits of a uniform approach. In some jurisdictions issuers use contract law and other aspects of the local legal system to define and set up a particular covered bond issue, ensuring that it conforms to the minimum EU (if relevant) or other applicable standards (to be recognised as eligible investment) as well as to meet investors' expectations. Issuing covered bonds based on contractual arrangements and without a specific covered bond legal framework is possible and realistic only in jurisdictions where certain specific elements usually expected in covered bond structures are well supported by existing law and there is a great body of jurisprudence confirming the enforceability of such structures (for example, in England and Wales).

The majority of civil law countries opt for the creation of specific legislation and regulation which would support the issuance of covered bonds. When doing so several legal and regulatory steps are usually required for the development of a covered bond framework. Primary legislation usually defines covered bonds within a jurisdiction by setting rights and duties of parties to an issue; determines a model of structure; establishes supervisory and regulatory roles empowering the regulator to pass relevant regulations and removes any existing impediments to the creation of a chosen structure. Secondary regulations usually contain criteria which when met ensure that covered bonds conform to desirable market

CHART 2

OUTSTANDING COVERED BONDS IN EURO BILLIONS



standards that will attract investors, such as a “best practice”, as defined by the EBA in the European Union. In addition to eligibility criteria, regulations also usually introduce prudential rules of protection of all stakeholders and the financial system in general. And lastly, the legislator should ensure that various investor laws and regulations (for example, pension fund laws) correctly treat covered bonds, that is, place them in an asset class that adequately reflects its low risk and liquidity characteristics.

WHAT COVERED BOND MODELS DO THE EBRD'S COUNTRIES OF OPERATIONS CHOOSE?

Generally speaking there are four models of covered bonds structures currently used in Europe. Depending on the chosen model various aspects of local laws need to be reviewed and potentially modified in order to make the structures work. These include issues such as transferability of loan agreements, enforceability of transferred mortgages, segregation of cover pools in case of issuer insolvency, recognition of trust or similar agency structures, priorities and potential set-off rules of various stakeholders, and so on.

In an “on balance-sheet model” banks issue bonds which are secured on a pool of assets retained on balance sheet but “ring fenced” from other creditors in the event of insolvency. Typically the pool of assets is recorded in a “cover register”. Normal insolvency law is amended to recognise the special rights of covered bond creditors in insolvency, for example, the appointment of a party to protect their interests and/or specific amendments to normal insolvency procedures. In some jurisdictions the cover pool acquires legal personality in insolvency. This model is frequently used when the insolvency law can be adequately modified to accommodate a clear segregation of assets and derogation from normal insolvency procedures. This structure is used, for example, in Germany and Spain.

In a “special bank model” a special bank which is incorporated and wholly owned by the normal commercial bank issues the bonds. This bank is regulated and capitalised as a normal bank but has activities highly restricted to the origination of qualifying assets (or their purchase from their parent) and the funding thereof by the issue of covered bonds. Typically over-collateralisation (OC)

is funded by both the capital of and a subordinated loan from their parent. This model is more onerous to set up but provides greater legal certainty of asset ownership in cases where insolvency law is difficult to modify.

In a typical SPV model a bank issues an unsecured bond. At the same time it segregates a pool of assets in a bankruptcy-remote SPV which issues a guarantee of the payments due under that bond. The pool of assets on which the guarantee is based is structured on a revolving basis. Payments are only ever made by the SPV if the bond issued by the bank defaults. This model is typically used where the legal technology exists to easily transfer the beneficial ownership of assets to an SPV.

In an agency model a group of banks collectively owns an entity which extends them loans (or buys their bonds) secured on a pool of assets and funds this purchase in the bond market. Several variations on this basic model exist but none is widely used.

A model's selection in a jurisdiction ultimately depends on a combination of various factors such as legal heritage, compatibility with existing rules in a jurisdiction, the heaviness of necessary legal and regulatory changes and the policy views of regulators. In some jurisdictions, for example, Greece, it is even possible to choose between several models.

As already mentioned, apart from choosing a structure model and re-shaping legal rules to fit it, a legislator and/or a regulator also needs to draft a set of regulations that would determine bank assets that are allowed to be pooled in cover pools (for example, mortgages, small and medium-sized enterprise loans, and so on). Those regulations also need to determine the so-called eligibility criteria which prescribe minimum LTV ratio limits,⁴ the calculation method of the assets' value in the pool,⁵ revaluation frequency and methodology, treatment of impaired assets, and so on. Other aspects to be regulated include measures of credit risk mitigation,⁶ requirements for mitigating market risk by entering into swap contracts, availability and determination of substitute assets, various reporting rules to the regulator and investors, authorisation requirements and monitoring rules.

In any event the ultimate goal of any legislator introducing or modifying a legal framework for covered bonds should be to create a framework that would ensure that covered bonds issued in accordance with those rules satisfy investors' demands both from the market (liquidity, stability, transparency) and regulatory capital standpoint (preferential treatment).

EBRD SUPPORT OF COVERED BONDS REFORMS

The EBRD actively engages in the development of covered bonds markets in its countries of operations. The Bank supports this through all available tools: (i) policy dialogue; (ii) technical cooperation; and (iii) investments. From the transition perspective, the EBRD considers the benefits of development of covered bonds markets to be two-fold, it supports the development of local capital markets by increasing available methods of capital markets financing, and, supports stable and responsible housing finance.

In the following section we examine developments in the area of covered bond law in the EBRD's countries of operations profiling three EBRD jurisdictions that have relatively recently undertaken, or are undertaking, covered bond legal reforms and where the EBRD has played an advisory role, namely Poland, Romania and Croatia.

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POLAND

Due to various factors, the Polish covered bonds market has never developed, although the favourable market conditions exist. This was mostly due to two factors: (i) an outdated legal framework (the Act on Mortgage Bonds and Mortgage Banks from 1997) and; (ii) the covered bonds structure model whereby only mortgage banks were/are allowed to issue covered bonds, while over 95 per cent of mortgages were granted by universal and not mortgage banks. The existing framework required updating and alignment with international standards. The levels of outstanding covered bonds in Poland were lower than in Hungary, or the neighboring Slovak Republic or the Czech Republic. In order to create the market, participants, the Ministry of Finance and the EBRD worked together to create a new legal and regulatory framework for covered bonds in Poland.

Such work resulted in a new covered bond legislation. On 24 July 2015 the Polish parliament approved an amendment to the existing covered bond framework, the Act on Mortgage Bonds and Mortgage Banks. Amendments were also introduced to the Polish bankruptcy law. The changes came into effect on 1 January 2016 and are likely to lead to a significant increase in issuance of Polish covered bonds as they become a more attractive way for banks to increase their long-term funding base. The amendments are also the first in Europe providing for a pass-through structure (which will be explained in more detail later).

As already indicated, Polish covered bonds can only be issued by specialised mortgage banks (currently only three have such a licence), of which only two are active issuers of covered bonds (Pekao Bank Hipoteczny SA and mBank Hipoteczny SA). PKO Bank Hipoteczny is the newest mortgage bank, but it is expected to issue its first covered bond at the beginning of 2016.

In 2016 the Polish covered bonds' landscape is expected to change with new Polish zloty- and euro-denominated benchmark issuances and new mortgage banks applying for the licence.

The revised Polish covered bonds law remains fairly traditional. Inspired by German legislation, Polish covered bonds can be secured by mortgage loans or by public sector debt. Residential mortgage loans can be used as collateral for covered bonds up to a maximum 80 per cent of the value of the underlying property (LTV ratio). For non-residential mortgage loans the LTV ratio is 60 per cent. Mortgage banks

are not allowed to originate or acquire mortgage loans with a LTV ratio higher than 100 per cent. The collateral for public sector covered bonds can consist of debt issued or guaranteed by central governments or central within the European Union or the Organisation for Economic Co-operation and Development (OECD), except for states that are currently in the process of restructuring or have restructured their foreign debt within the last five years. Substitution assets, which can consist of cash, central bank deposits or public sector debt eligible as ordinary collateral, are limited to a maximum of 15 per cent of the volume of collateral required to cover the outstanding covered bonds. Derivatives used for hedging purposes can also be included in the cover pool.

An independent cover pool monitor needs to be appointed for each covered bond issuer by the Polish Financial Supervisory Authority (KNF). The main task of the cover pool monitor is to ensure that the issuer complies with the coverage requirements set out by the covered bond framework. The framework now also requires a nominal minimum OC of 10 per cent. This limit is a minimum, and banks, hoping for a higher rating uplift, will have to comply with the expectation of rating agencies that may ask for a 20 to 30 per cent level of OC. The total nominal amount of outstanding covered bonds may not exceed 40 times the issuer's own capital.

What happens if the mortgage bank enters into bankruptcy and what is the so-called "pass through structure"?

In case of bankruptcy, the cover pools and covered bonds are split from the issuer's balance sheet and an administrator, who represents the rights of the covered bondholders, will be appointed by the bankruptcy court. The maturity dates of all outstanding covered bonds will automatically be extended by 12 months. Interest payments on outstanding covered bonds will continue to be made as specified in the terms and conditions of the bond in question.

Within three months of the date of announced bankruptcy of the issuer, the insolvency administrator will perform a coverage balance test, which examines whether the cover pool is sufficient to satisfy all claims arising from the outstanding covered bonds. If this test is passed, a liquidity test will be conducted, which examines whether the cover pool is sufficient to satisfy all claims arising from the outstanding covered bonds at their extended maturity date. If the liquidity test is also passed, the covered



bondholders' claims are satisfied in accordance with the terms and conditions, taking into account the automatic maturity extension by 12 months. Subsequent liquidity tests will be performed every three months and subsequent coverage balance tests every six months.

In the event of a failed liquidity test, maturity dates of all outstanding covered bonds will be extended to three years after the due date of the last maturing cover asset. Covered bondholders will be repaid pro rata on a pass-through basis. The same applies if a coverage balance test is failed. A bondholder meeting can be called to decide, with a two-thirds majority, whether the cover pool should be liquidated and the proceeds distributed among the covered bondholders instead of a pass-through repayment.

In addition, Polish covered bonds meet the requirements of Article 52(4) of the Undertakings for Collective Investment in Transferable Securities (UCIT) Directive and those set out in Article 129 of the Capital Requirements Regulation (CRR). Therefore, Polish covered bonds could qualify for a preferential risk weighting under the CRR.

In terms of a rating uplift, the major rating agencies specified that the new legal and regulatory framework would allow for a higher maximum rating uplift than the current maximum of two to three notches. 2016 may be the year of Polish covered bonds.

ROMANIA

To establish a legislative framework in line with best practices, the Romanian parliament adopted a new covered bond law in September 2015. The new law replaces Law no. 32/2006 that had many deficiencies and has never been used. The new law conforms to: (i) the definition of covered bonds as per EU legislation including the Capital Requirements Directive and the UCITS Directive; and (ii) the “Best Practice” supervisory guidelines as published by the European Banking Authority. It is expected that the Romanian covered bonds will be exempted from bail-in application⁷ of the Bank Recovery and Resolution Directive (BRRD) similar to other countries in the European Union.

According to the new law, commercial banks in Romania can issue covered bonds that are backed by a pool of commercial and residential mortgage loans that are ring-fenced from the bank’s balance sheet in a bankruptcy situation. This structure would offer a double layer of protection to investors: first they will have recourse to the issuer and if the issuer is not able to honour the obligations under the covered bond programme they will have access to the cash flows of mortgage loans. The National Bank of Romania is responsible for the regulation and supervision of covered bonds, including post-issuer default, and for drafting the secondary legislation.

The new law includes specific provisions to reduce the collateral and refinancing risk, while depending on the hedging arrangements, covered bonds investors can still be subject to foreign exchange risks.

While the maximum LTV ratio for residential mortgage loans is maintained at 80 per cent (60 per cent for commercial real estate)⁸ in the calculation of the cover, only 60 per cent of the property market value securing the mortgage loan will be considered. This additional requirement offers extra protection to investors as it secures against a decrease in the real estate market value. In this situation, issuers will need to add more mortgage loans to the pool to be able to satisfy the cover tests. Another provision to reduce the collateral risk is the requirement for the issuer to include and maintain in the cover pool performing loans only (maximum 15 days overdue)⁹ which represents a significant improvement compared with the previous law (which referred to overdues over 60 days) and offers additional protection to investors against a deterioration of the macroeconomic environment. The new law introduces provisions to protect investors against the liquidity risk. Legal minimum OC is set at 2 per cent on a net present

value basis, however higher OC can be committed through the covered bond programme.¹⁰ The issuers will have to demonstrate that they will be able to comply with this requirement in a crisis situation. In addition to the minimum OC, issuers will have to pass a maturity test. Issuers will have to ensure that for the next 180 days the difference between the incoming and outgoing cash flows on a daily basis is covered by liquid assets.¹¹ To further protect against the liquidity risk the law allows for the covered bonds to be structured as a conditional pass-through or soft-bullet eliminating the automatic acceleration on the insolvency of the issuer.

The law does not envisage any minimum requirements with regards to foreign exchange risks which might expose investors to currency risks. The issuers are allowed to use derivatives as part of the covered pool but it is up to the issuer to choose the most effective structure.

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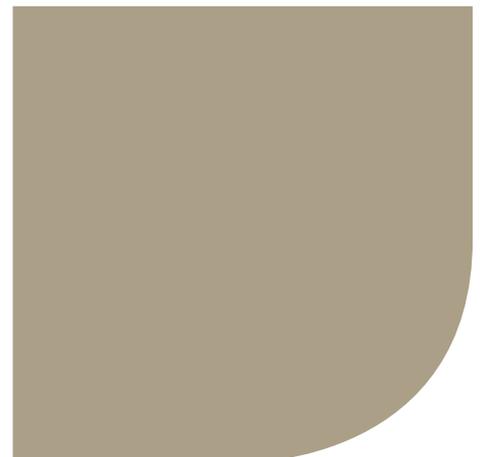
CROATIA

Covered bonds are currently not specifically regulated in Croatia which creates an insurmountable hurdle for potential issuers since elements typically expected, such as segregation and transfer of cover pool assets or insolvency ring-fencing, are not supported under the current legal framework. As a consequence of the transposition of EU law, some pieces of Croatian legislation do mention or refer to covered bonds¹² but without defining them and without providing an overarching legal structure. At the same time it seems that market players have started paying attention and are looking into the possibility of issuing and/or investing in locally issued covered bonds.

This is the reason why the Croatian government decided to introduce a covered bond law which would address the existing bottlenecks and introduce regulations setting minimum standards in conformity with the eligibility criteria established in the Capital Requirements Regulation.

According to the initial plans of the government Croatian covered bonds will be debt securities issued by regular commercial banks and secured on a pool of loans where loans are secured with hypothecations or fiduciary transfer of ownership on the real property of the borrower (mortgages).

It seems that the on-balance-sheet model of structuring covered bonds would be preferred in the Croatian case as this model reduces the need for formal transfers of loans which in local circumstances would be a rather complicated process. The need for transfer would only arise if the issuing bank defaults (or is likely to default), which is the case only in exceptional circumstances. From that point of view, it is the simplest model to implement, requiring the fewest number of steps. In addition, from the investors' perspective, this model makes it quite clear that the issuing bank is fully liable for the performance of the bonds, a fact not to be neglected in the developing covered bond jurisdiction. However, even in this relatively straightforward structure several issues were identified as major or potential stumbling blocks,



which will have to be addressed in order to create an efficient legal environment for issuing covered bonds in Croatia.

As it currently stands certain claims of a bankrupt bank's employees, the central bank's claims, secured deposits and claims of the deposit guarantee agency would have priority over the claims of the bondholders in case of insolvency.

A new legal framework would therefore have to create clear and certain rules that would provide for ring-fencing of cover pool assets from the rest of the issuer's insolvency estate to avoid competing claims from those types of creditors. In particular, the new regime should follow the "Best Practice" supervisory guidelines of the EBA, as well as requirements laid down in Article 52(4) of the UCITS directive, which requires that in the event of the issuer's failure, the cover assets are to be used on a priority basis for the reimbursement of the principal and payment of the accrued interest.

In order to allow for the cover pool to survive and to continue to service the bonds after the issuer's insolvency, any new legislation should remedy current legal hurdles by introducing a simple and straightforward method of assets transfer from the cover pool to an administrator which would have legal and effective protection against the challenges of other unsecured creditors, as well as the possibility to enforce collateral in the case of default of the borrowers in the cover pool.

In addition, under the current legislative regime, there seems to be a risk of delays to payments on covered bonds in insolvency (a stay-on payment or similar), including under the bank resolution regime where a deposit guarantee agency is authorised, for the purpose of protection of secured deposits, to transfer secured deposits which are collateral in the covering portfolio without transferring other assets, rights and obligations; or transfer, convert cash assets, rights and obligations without transferring deposits. The new legislation should clarify that measures undertaken within the bank resolution regime shall not prevent payments to the bondholders from the pool of cover assets. Apart from resolving priority issues over the cover pool the new legislation



1 Source: The European Covered Bond Council.

2 http://ec.europa.eu/finance/consultations/2015/covered-bonds/index_en.htm (last accessed 12 January 2016)

3 Provisions relevant for covered bonds in the European Union can be found in other pieces of EU law as well, for example Article 52 of the Directive, 2009/65/EC of 13 July 2009, prescribing investment limits and eligibility for undertakings for collective investment in transferable securities (UCITS).

4 EU Capital Requirement Regulation (575/2013) sets this maximum at 80 per cent.

5 For example, market value, mortgage lending value, and so on.

6 Usually by mandating replacements of impaired assets and over-collateralisation.

7 The EU Bank Recovery and Resolution Directive (2014/59/EU) (the "BRRD") is part of a series of EU banking reforms made in response to the financial crisis and establishes a framework for the resolution of failing financial institutions. It gives regulators a range of tools to do this, including bail-in powers to write-down and/or convert into equity certain liabilities of a failing institution.

8 Article 18 (4) of the new covered bond law.

should also limit or prohibit set-off possibility which currently borrowers under loans in the cover pool enjoy in respect of their claims against the issuer. Alternatively, the new legislation should introduce an over-collateralisation model which will adequately account for this set-off risk.

In addition to the rules that would facilitate the creation of covered bonds and the legal protection of bondholders' rights in Croatia it will also be necessary to define the rights and obligations of cover pool administrators, prescribe reporting standards and eligibility criteria in accordance with the CRR as mentioned above and introduce a supervisory regime.

The Croatian National Bank should be granted the supervisory powers in order to run a dedicated supervisory regime for covered bonds. This, if done in alignment with the EBA Best Practices, assumes that the competent authority approves the establishment, by a given issuer, of a covered bond programme in accordance with a clear and sufficiently detailed set of criteria for approval and, in general, an explanation of duties and powers of the competent authority. The year ahead promises to be an exciting one in terms of the development of Croatian covered bonds and the capital market in general.

CONCLUSION

It appears that covered bonds are becoming more and more popular in the EBRD region and this has been reflected in the increased legislative activity in various EBRD countries of operations. There are many benefits of developing a covered bonds market and these can generally be grouped into

three main categories depending on the issuers, investors and/or the systemic perspective.

For the financial institutions they are an effective way of attracting long-term funding at reasonable cost and this can be translated into cheaper mortgage lending to retail customers. In the medium and long term the covered bonds influence the development of the primary mortgage market as the underwriting criteria will have to be aligned with the best international standards benefiting retail customers. The ultimate effect will be a more sustainable primary mortgage market.

For investors, these instruments offer the best protection as they are subject to controls from the regulator as well as rating agencies. Many domestic investors who are currently heavily exposed to a relatively narrow set of fixed income assets will therefore find a valuable tool for the diversification of both their credit and liquidity risks. It is expected that covered bonds are to be highly rated, liquid, long-term instruments suitable for local pension funds and insurance companies.

Covered bonds can also contribute to the development of the local capital market as these instruments will be listed on the local stock exchange and will facilitate the establishment of a liquid, high-quality bond market.

All of these features, coupled with beneficial market conditions for the development of covered bonds markets, indicate that the probable answer to the question posed at the beginning of this article is: yes, definitely "to bond".

- 9 Article 18 (1) (f) of the new covered bond law.
- 10 Article 13 (1) of the new covered bond law.
- 11 Article 13 (4) of the new covered bond law.
- 12 Open-Ended Investment Funds with Public Offering Act; Recovery Act; various subordinate legislation on the capital adequacy ratio of credit institutions and investment firms.

