

# **Covered Bonds as a Source of Financing Residential Properties in Poland**

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## Introduction

A modest potential of mortgage banks that was built over the past twelve years in Poland does not suffice to develop the system of refinancing housing credit with the use of covered bonds.

However, the more and more frequent liquidity problems of universal banks will enforce development of that system in Poland.

### 1. Covered bond definition

Covered bonds are debt securities, and in their function they are similar to bonds<sup>1</sup> Hence, similarly to bonds, they are classified as securities that serve as certificates of debt. The issuer of covered bonds pledges to satisfy certain monetary obligations to the investor, as stipulated by terms and conditions of issue. Pursuant to Polish legal regulations, mortgage banks are the only entity authorized to issue covered bonds. Pursuant to the Act on Covered Bonds and Mortgage Banks, covered bonds are either transferable bonds or bearer bonds.

There are two main types of covered bonds:

- a) Mortgage covered bonds whose issue is based on credit granted by mortgage banks, secured by property.
- b) Government mortgage backed bonds whose issue is based on:
  - Credit granted by mortgage banks, fully secured by a guarantee or pledge from the bodies stipulated by the Act such as State Treasury, National Polish Bank, European Union or entities of its member states, European Central Bank, EU member states governments or their central banks, OECD, territorial government entities
  - Encumbrance of a mortgage bank by credit granted to the above mentioned entities

Stipulations of both types of bonds oblige the issuer to pay the investor benefits specified by the terms of the contract. Those include repayment of the principal and interest, payable on dates specified by the contract. Interest payments may be based on a fixed or floating interest rate, in line with the dates listed on the coupons, enclosed to covered bonds. Payments to mortgage covered bond holders may be denominated in PLN or in foreign currencies. The Act stipulates that covered bonds may take form of a document, or they may be traded as a virtual instrument. In the latter case the holder receives from the issuer a certificate of deposit.

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<sup>1</sup> G.Główka, System of financing residential properties in Poland. Experience and directions of changes. SGH Publishers. Warsaw 2012, p.136

Covered bonds have certain functions in the financial system, such as:<sup>2</sup>

a) Mobilization of capital

It means that capital raised by issuing covered bonds can be used only for credit granted by mortgage banks.

b) Circulation; as any security, covered bonds may be sold and bought by the current holder in line with the principles of trading securities

c) Guarantee by the specific nature of security for bondholders

**2. Position of covered bonds on the market**

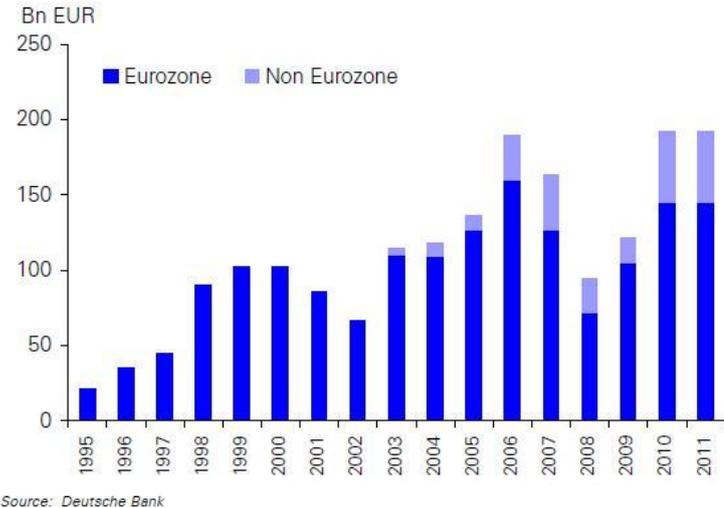
Covered bonds are popular almost entirely with the European banks. They are regulated by legal acts by most European jurisdictions.

Last ten years have brought a dynamic growth to the market of covered bonds. On average, it grew by 8% each year, and such growth rate has been sustained even during the crisis.

Apart from the traditional issuers from France, Denmark and Spain, there are new ones on the market: from Portugal, Scandinavian countries. Just before the crisis that market was joined by Italy and Greece, and most recently Canada, Australia and New Zealand.

Changes on the market of covered bonds noted within 1995 – 2011 showing the volume of issues are shown in Figure 1.

**FIG.1 Issue of covered bonds in bln EUR**



<sup>2</sup> Act on covered bonds and mortgage banks of 29 August 1997, Journal of Law, 2003, issue 99.

Due to financial crisis the role of covered bonds as a source of refinancing for banks became even stronger.

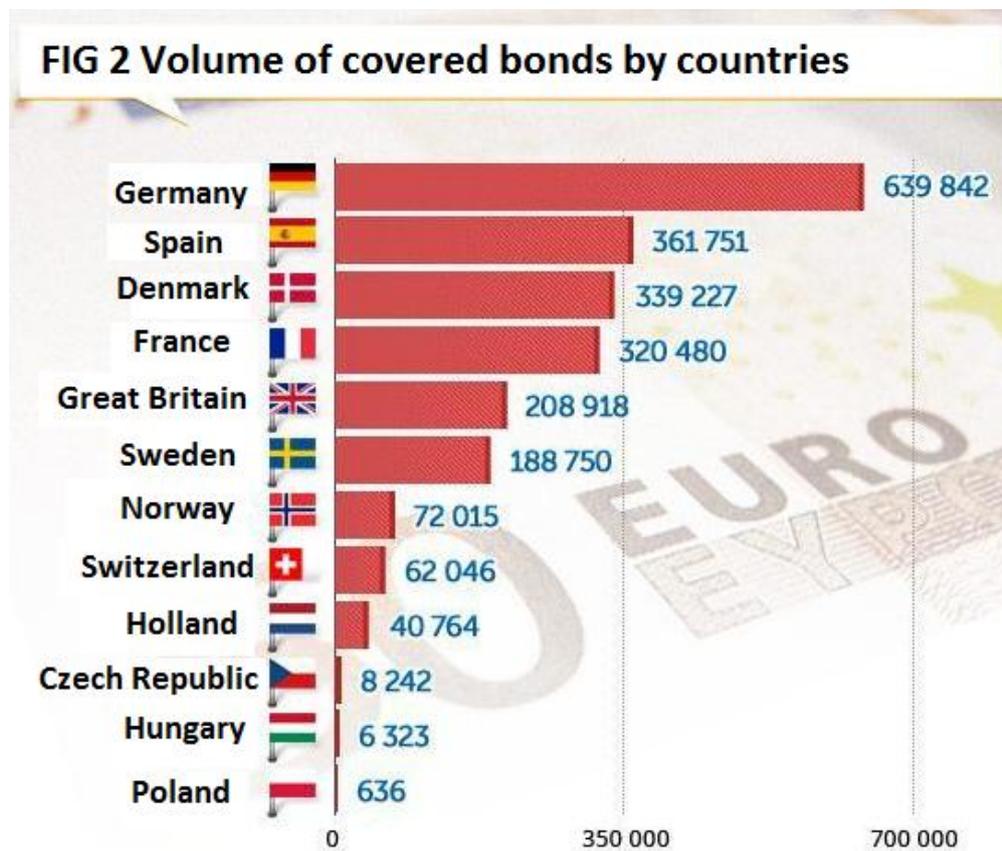
### 3. Market of covered bonds in Europe

Currently there are four various methods of issuing covered bonds in Europe. Covered bonds may be issued by:

- a) Specialized financial institutions (France, Ireland, Norway)
- b) Specialized banks (Denmark, Hungary, Luxembourg, Poland)
- c) Universal banks
  - Banks with a conditional licence for issuing covered bonds (Austria, Cyprus, Finland, Germany, Greece, Iceland, Latvia, Russia, Slovenia, Sweden)
  - Banks without a conditional licence (Bulgaria, the Czech Republic, Lithuania, Portugal, Romania, Spain, the Slovak Republic)
- d) Special Purpose Vehicle (SPV) (to gain separateness of liquidated assets) (Italy, Holland, Great Britain)

Charts 2,3 and 4 illustrate the market of covered bonds (mortgage and public) in European countries. The charts clearly show negligible role of Poland on that market.

Nevertheless, such a small scale indicates a large growth potential (Figure 5).



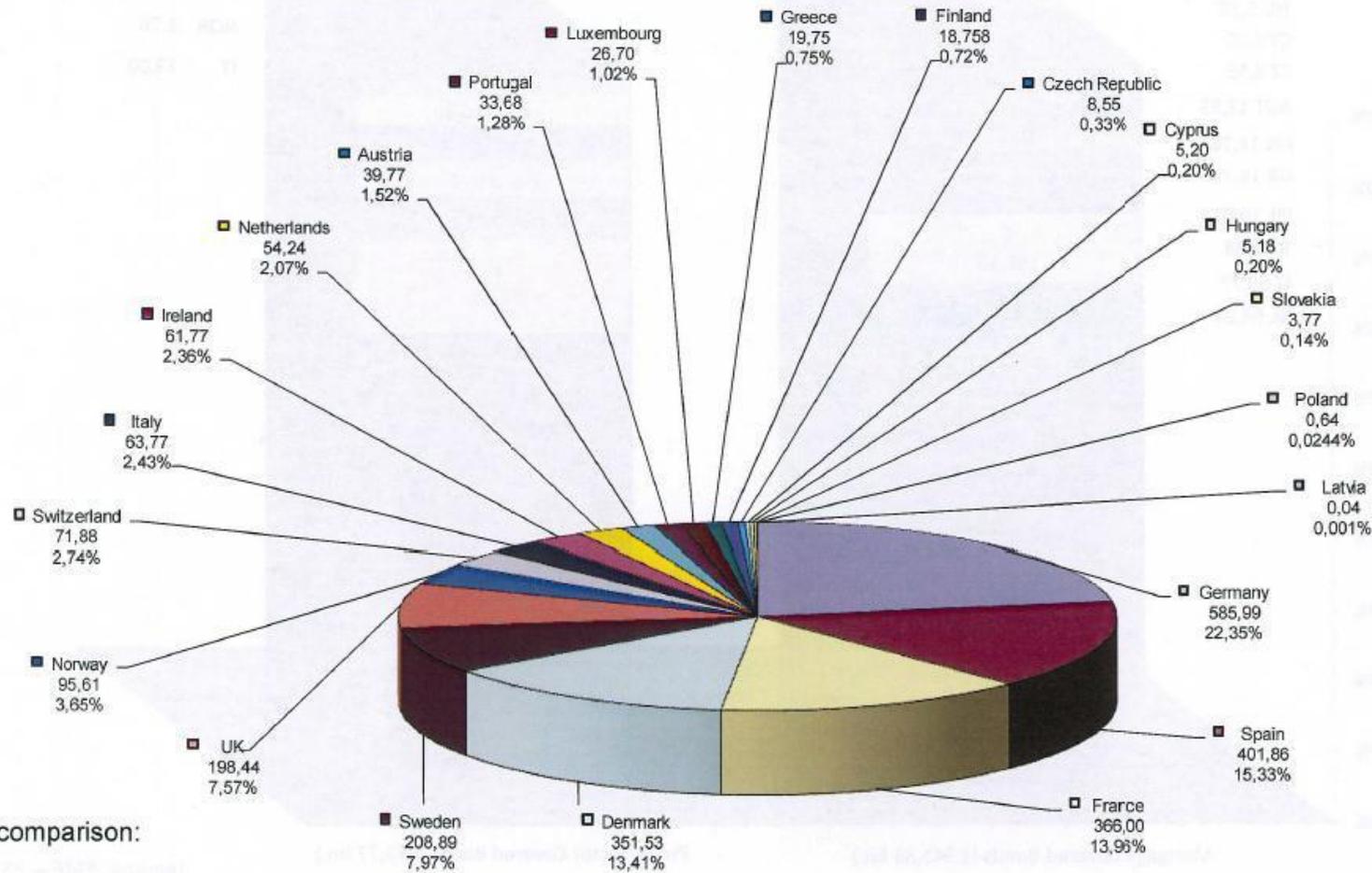
\* mln euro – as of 2010

Source: ECBC

# Market Share of the European Covered Bond Countries in the European Covered Bond Market (end of 2011: 2.622 bn €)



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For comparison:

Canada: 38,61 bn.

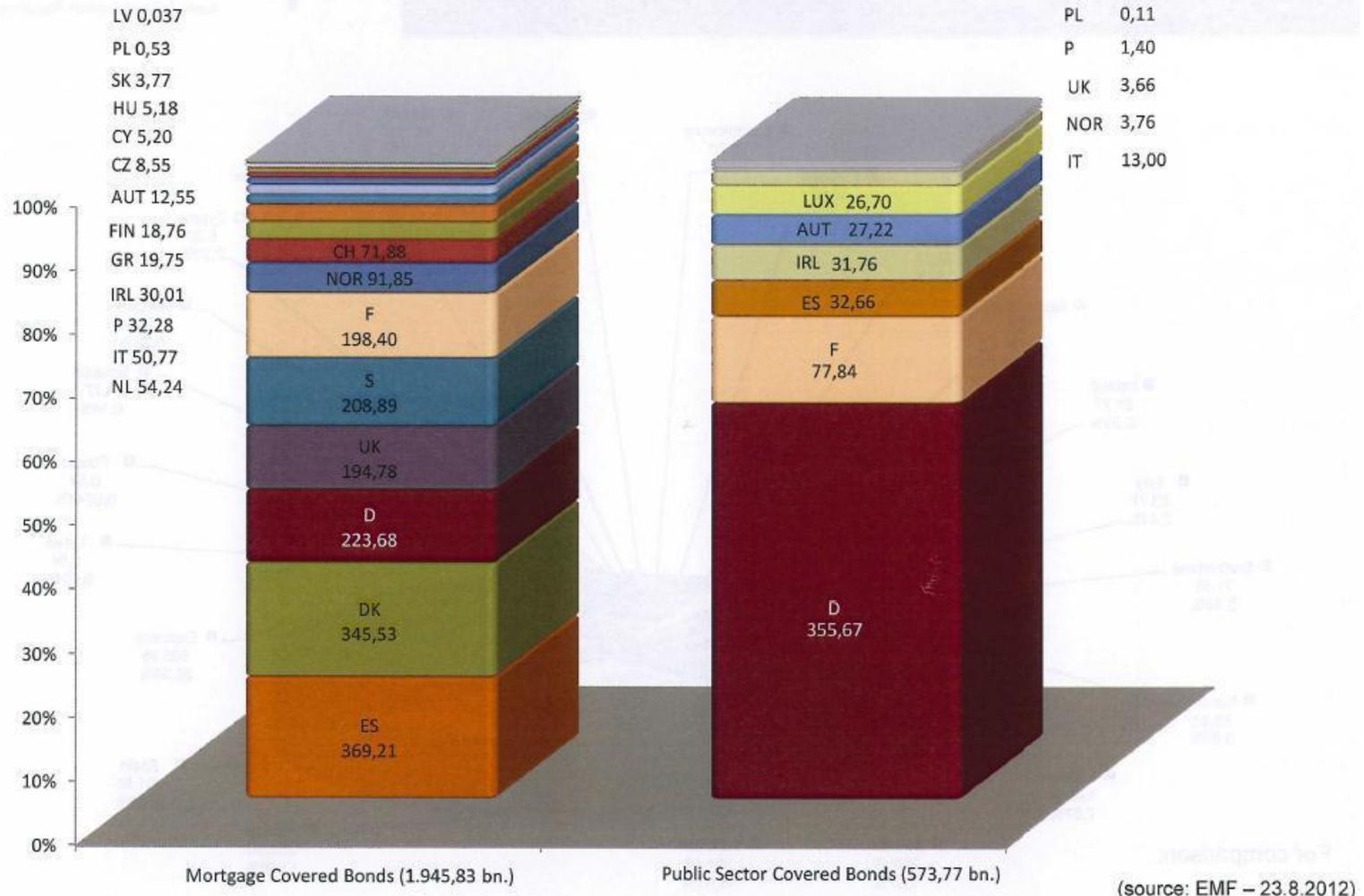
USA: 9,54 bn.

(source: ECBC – 23.8.2012)

# Public Covered Bonds in the EU compared with Mortgage Covered Bonds (as at end of 2011, in bn. EUR)



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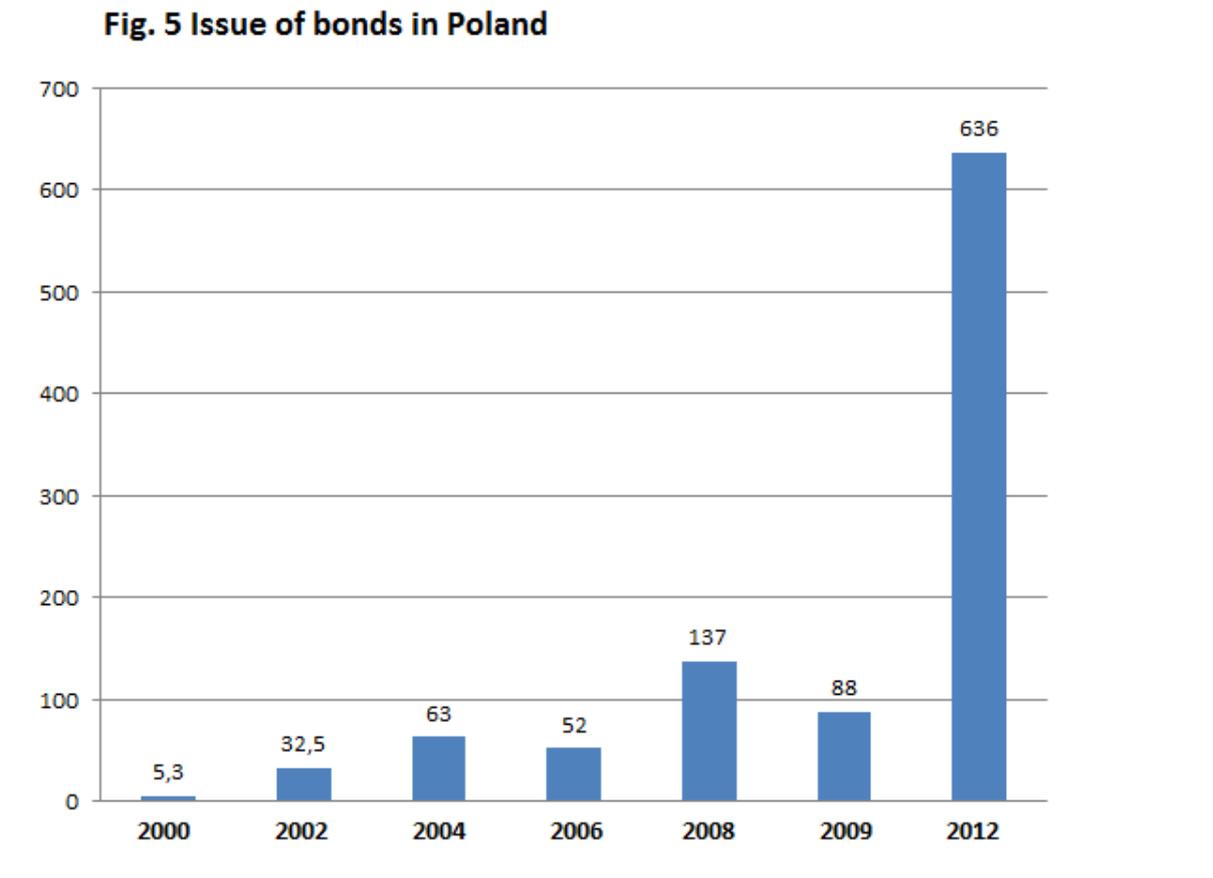


#### 4. Market of covered bonds in Poland

Due to a relatively short period of functioning of Polish mortgage banks as well as negligible volume of granted credit, the issue of covered bonds was also low. (Chart 5)

Figure 5

Issue of covered bonds in Poland (in million EUR)



The volume of credit granted by mortgage banks to finance purchases of properties amounted to 2.04% of the total of real property credits granted by the whole banking sector<sup>3</sup>

That means that the role of specialized mortgage in granting mortgage loans for the purchase of real estate in Poland is marginal. At the same time it is worth noting that covered bonds play quite an important role in refinancing long term mortgage credits in many countries (Table 1)

<sup>3</sup> Financing of real estate by banks in Poland. Data for December 2008, Commission of Financial Supervision, Warsaw 2009

**Figure 6 Financing of mortgage loans with covered bonds within selected countries in 2009**

<b>Country</b>	<b>Mortgage loans (billions EUR)</b>	<b>Covered bonds (billions EUR)</b>	<b>Ratio of covered bonds to mortgage loans</b>
France	700.8	119.1	17.0
Spain	674.4	307.5	45.6
Portugal	105.2	15.3	14.5
Sweden	199.1	126.4	69.5

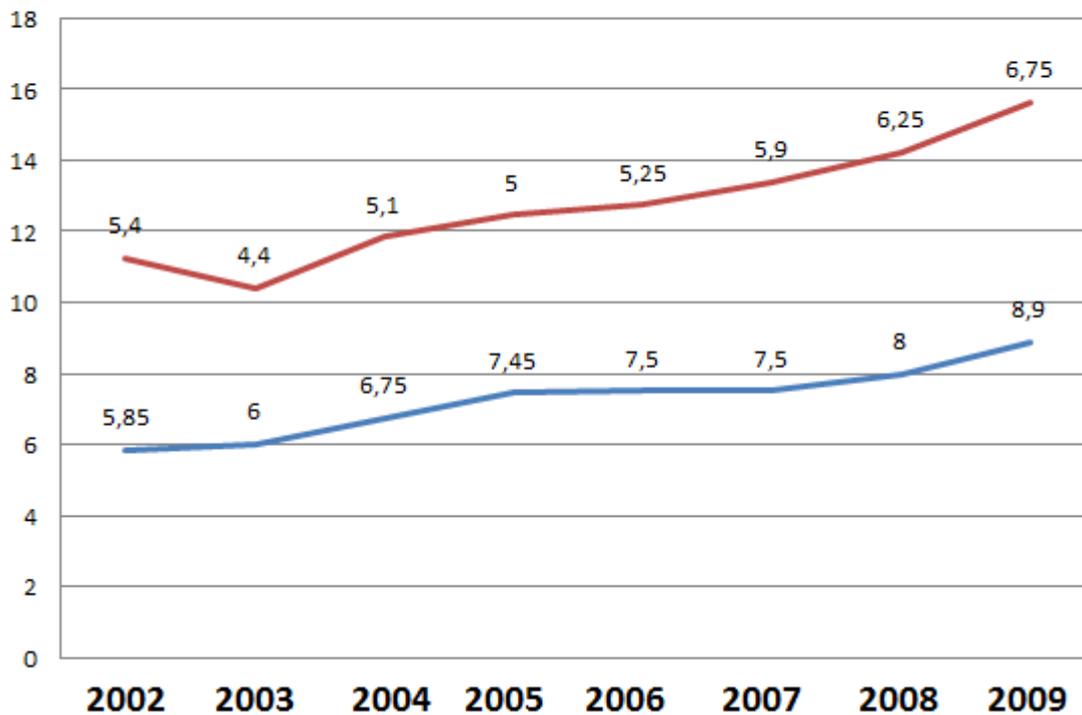
Source: P. Cyburt, Polish covered bond; a retrospective after ten years, in *"Financing real estate"*, 2010, issue 3.

Under those circumstances covered bonds function as an important factor stabilizing liquidity of the financial sector by improving the structure of maturities of assets and liabilities on the balance sheets of banks granting long term real estate loans, mostly earmarked for the purchase of residential properties.

Interest rates charged for covered bonds are usually set by referring them to the interest rate on Treasury Bonds. Table 6 presents interest rates on covered bonds and on T-bonds.

**Figure 7 Market interest on T-bonds and covered bonds in Poland.**

## Interest rate of polish T-Bonds and bonds in Poland



Source:

Annual report 2009, Foundation for Mortgage Loans, Warsaw 2010.

The above graph demonstrates that the difference on Polish covered bond market is significant, and it has been sustained at 200 base points. However, on the markets of the developed EU countries that differences ranges from a few to a dozen points.

To give an example, German covered bonds are so credible that they are traded at 15 – 20 base points below German T-bonds.

### Conclusion

Market of covered bonds has not been developed in Poland for a variety of reasons:

- Until recently interbank market has been functioning efficiently and it showed excessive liquidity
- Banks had no problems with financing by holding companies
- Financing was cheap, and long term instruments were not profitable

Two criteria must be fulfilled to make covered bonds more attractive on Polish market:

Covered bonds should:

- Offer appropriate economic benefits ,thus ensuring profitability of transactions
- Ensure safety to investors, in this way generating demand for the issue of covered bonds

Further work should be focused on preparing consistent amendments of legal acts that would comprise:

1. Changes in the regulations on issue of covered bonds (tax regulations, improving the rating of covered bonds, possibility to qualify covered bonds as liquid assets)
2. Changes in the regulations on transferring properties from a universal bank to a mortgage bank (transfer of portfolios between banks, tax issues, etc)

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