European Bank
for Reconstruction and Development

INTRODUCTION OF A COVERED BOND AND SECURITISATION LEGAL AND REGULATORY FRAMEWORK IN LATVIA

7 February 2019

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1 Executive summary

Covered bonds and securitisations both have the ability to provide significant benefits for Latvia including improvements to the funding of the real economy, increasing the stability of bank funding and generating a group of high liquidity and credit quality investments for domestic investors.[1] Also, the development of both securitisations and covered bond markets are key objectives of the European Commission's Capital Markets Union initiative.

In order to realise these benefits, enabling legislation will be required and, in the case of covered bonds a supervisory framework will need to be established.

Given the nature of the covered bond market in particular and the cross-border lending practices of many of the mortgage lenders in the Baltic states, it would be highly advantageous to develop the covered bond market in Latvia in full coordination with the development of covered bond markets in Estonia and Lithuania in order to produce a pan-Baltic covered bond market. This coordination will be conducted in accordance with the Memorandum of Understanding signed by the Finance Ministries of all three states in October 2017 on the creation of the pan-Baltic capital market.

In this concept paper we address the following points:

Section 2. Scope

This project was established by the EBRD and is led by the Local Currency and Capital Markets Team. It is funded by the European Union via Structural Reform Support Service.

This paper is designed to ensure a broad understanding of both of the instruments and to facilitate a consensus on the process by which they may be introduced into Latvia.

After a stakeholder consultation, this concept paper will form the basis and a roadmap of a draft securitisation and covered bond law.

Section 3. Description of Asset Backed Securities and Covered Bonds

Asset Backed Securities ('ABS' or 'securitisations') and covered bonds are both secured debt instruments. In the case of ABS, investors have recourse only to a pool of assets, in the case of covered bonds they additionally have recourse to the Issuer of the bonds. In addition, covered bonds are restricted with regards to their underlying assets and the entities which can issue them.

The laws governing both ABS and securitisations are member state competencies but in both cases the instruments must conform to standards laid down in European Union directives in order for the instruments to qualify for certain preferential prudential rules for investors. In the case of securitisations, the relevant directive is the STS Regulation[2] which came into effect on 1st January 2018 (but which is still subject to certain regulatory technical standards). In the case of covered bonds, the relevant directive[3] is currently being negotiated in the trilogue process and it is anticipated that it will be passed into law by the end of 2018.

[1] See, for example, Moody's analysis on 22.01.2018 "Proposed Baltic Covered bond market is credit positive for local banks", and HSBC "Go- East: Covered Bonds in Central and Eastern Europe", January 2018.
[2] Regulation (EU) 2017/2402 of the European Parliament
[3] Draft version: www.ec.europa.eu/info/law/better-regulation/initiatives/com-2018-94_en

Section 4. Overview of the ABS and covered bonds structures and features

ABS are typically structured via the transfer of assets to an independent entity which issues bonds to fund the purchase. This requires several intermediate steps which may require legislative actions to facilitate.

Covered bonds on the other hand can viably be structured in different ways. We recommend that Latvia adopts a model whereby assets are transferred to a separate SPV (as this term is defined in a glossary attached to this concept paper) which issues a guarantee of the Issuer's obligations under the bond. This model helps to enhance the extent of segregation of the cover assets from the Issuer (in comparison to the model where cover assets remain on balance sheet of the Issuer) and, therefore, to enhance the quality and legal reliability of the priority claim enjoyed by the investor on the cover assets. This is the covered bond model used in, for example, the Netherlands, Italy and the UK and is proposed in Lithuania.

This will achieve a high level of legal certainty for investors, will minimise the costs of establishing programmes (in comparison of the Special Bank model or Agency model requiring a larger scale), in particular for smaller borrowers and will require less additional changes to existing laws, for example the insolvency code.

This section also describes how the covered bonds laws to be passed in all three Baltic states should be coordinated in order to achieve the objective of a pan-Baltic framework.

Section 5. Application of the features of ABS and covered bonds in Latvia

Building on the necessary legal structure for securitisations and our recommended legal structure for covered bonds we will need to put in place certain legal building blocks. In order to transfer assets into a bankruptcy remote entity (a 'Special purpose vehicle' or 'SPV') and for these assets to provide sufficient protection for investors, it should be analysed whether certain amendments have to be made to Latvian law, in particular with regard to the establishment of a suitable legal entity, the appropriate means of asset transfer, the enforcement of security and the creation of security interest. In addition, legal certainty of the tax regime applicable has to be established.

Section 6. Pan-Baltic issuance of covered bonds

In addition to the structuring within Latvia, a harmonised legal framework is required to achieve pan-Baltic covered bonds issuance. This means that each Baltic state will have its own covered bond law and secondary regulations, which should allow assets to be included in the Cover Pool from all three states and assets to be transferred into the Cover Pool in other countries. Hence, in certain areas laws and regulations should be identical to the greatest possible extent, e.g. - asset eligibility criteria, risk mitigation measures, criteria for third-parties involved in the structure, etc.

Section 7. Economic considerations

Covered bonds will be significantly cheaper than other forms of term debt for Latvian banks. Furthermore they will allow a better matching of asset and liability maturity profiles and access to funding in turbulent market conditions. However, it should be noted that there is currently little requirement for term funding in this sector. This is due to a combination of factors including high deposit to loan ratios, parental funding, and the absence of any pressure from a regulatory perspective for banks to put in place stable term funding. These factors are unlikely to persist in the long term given, inter alia, the limited ability of deposits to fund more rapid growth rates, the proposals of the Vienna 2 initiative and proposed amendments to the net stable funding rules in CRR.

A further consideration for a covered bond programme is the relatively high upfront costs of establishing it. As many banks active in Latvia are also active in Estonia and Lithuania, covered bond

laws in all three states that allow the pooling of assets in one programme will: a) allow the upfront costs of establishing that programme to be amortised over a bigger quantity of funding, b) will result in larger bonds (which will reduce the interest rate demanded by investors for the securities) and c) will allow greater operational efficiency, in particular with regard to the level of over-collateralisation require to support the credit of the securities.

Although securitisations have the potential to significantly enhance credit ratings and thus reduce the cost of funding assets it is difficult to quantify the potential economic saving without first understanding the uses to which the tool will be put.

Section 8. Decisions needed and next steps

On the basis of this concept paper we would appreciate feedback from all stakeholders on the concepts discussed. On the basis of this we propose to start drafting primary legislation which will further be circulated amongst all stakeholders before entering into the legislative process.

Appendices

Appendices to this paper describe the recommendations of the European Banking Authority with regard to covered bond laws and supervision, provide a cross-reference of the laws referred to in this paper at European Union level and provide a glossary of terms used in securitisation and covered bond transactions.

2 Introduction

2.1 Potential benefits of covered bond legislation

A covered bond market would produce various benefits to the Latvian economy, some of which can be quantified, most of which would be of a qualitative nature.

Covered bonds could generate a saving for Latvian borrowers in excess of €9.5mn per year. This is arrived at by multiplying the size of the residential mortgage market (currently €4.4bn[4]), by the average proportion of mortgages in Europe funded by covered bonds (circa 40%[5]) by the average long term saving of covered bond funding relative to senior unsecured term debt (54 basis points[6]).

<u>This value is likely to be a significant underestimate for several reasons:</u>

- It assumes that the relative costs of covered bonds and senior unsecured debt for Latvian banks will be the same as the average for all European banks over the long term. Given Latvia's current credit rating, overall spreads for all Latvian Issuers are likely to be higher, therefore the actual saving for covered bonds relative to senior unsecured debt greater.
- As the saving from issuing covered bonds is greater than the European average then, rationally, it would be likely that banks would use the funding tool more than the European average.
- The Latvian mortgage market is exceptionally small on European terms €2,729 / capita, compared with a eurozone average of €16,714/capita), therefore it can be expected to grow in the long term. Covered bonds are typically used more when mortgage markets are growing (due to the limited ability of deposits to fund this growth).
- It ignores the possibility of further savings from issuing commercial Mortgage Backed covered bonds.

<u>Non quantifiable benefits of a covered bond market include:</u>

- A greater source of assets which can be used to access emergency liquidity facilities from the European Central bank in a period of severe market stress. Covered bonds are the only 'own issued' securities which the ECB accepts as collateral in its liquidity framework.
- Greater investor diversification, to the extent that many covered bond investors do not buy senior unsecured bank debt currently. In times of market stress this will become a more significant benefit due to the rating uplift available for covered bonds (in the case of Greece, for example, covered bonds were an important source of funding when senior unsecured bonds would have been impossible to issue).
- Better asset and liability matching as covered bonds typically have longer maturities that more closely match the duration of the assets funded.

2.2 Scope of project

This paper has been produced as a part of a project undertaken by the European Bank for Reconstruction and Development ("EBRD") supported by Sorainen and Richard Kemmish Consulting Limited and funded by the Shareholder Special Funds administered by the EBRD and Structural Reform Support Service of the European Commission.

[4] Source: European Mortgage Federation.
[5] Sources: European Mortgage Federation and European Covered Bond Council.
[6] Source: Author's own calculation, see European Commission: 'Feasibility Study on European Secured Notes' October 2018.

The scope of the project is to advise and support the Ministry of Finance of the Republic of Latvia as they develop securitisation and covered bond markets. Specifically this includes, inter alia:

- an analysis of the existing pertinent legal, regulatory and commercial conditions;
- advise with regard to legal and regulatory changes that are required to facilitate the development of these markets;
- discussions with all stakeholders of the risks and benefits of the proposed instruments and, as an outcome of such discussions, identifying safeguards that need to be put in place;
- coordination with the teams undertaking covered bond law reforms currently in Lithuania and Estonia,
- other support, as required.

2.3 Role of concept paper

The purpose of this paper is to identify issues that would be appropriate to address in order to introduce covered bonds and securitisations in Latvia and on a pan-Baltic level, to provide a roadmap for the necessary legal and regulatory process, and to request permission to proceed to the drafting of the proposed act of parliament.

This note is to be delivered to the Ministry of Finance for discussion purposes. Subsequently, the intention is to share and discuss it with key stakeholders and other interested parties.

2.4 Process overview

On the basis of this consultation paper we will seek a consensus of stakeholders on the broad topics to be addressed and the way to undertake these.

For both proposed instruments the next step will be the drafting of primary legislation which will then be subject to normal consultation procedures. This consultation will necessarily bring up more detailed topics that will need to be discussed by all parties.

The Act of Parliament and supporting laws will (inter alia):

- define covered bonds and securitisations and their broad parameters;
- amend certain other laws;
- specify the scope of secondary regulations on more technical aspects;
- specify the investor protection standards that must be adhered to;
- address cross-border asset transfer matters.

Secondary regulations will then be needed to further clarify the legal and supervisory framework.

2.5 Creating Pan-Baltic market

In the spirit of pan-Baltic co-operation as mandated by the Memorandum of Understanding signed by the three Ministries of Finance, the covered bond reform in Latvia will endeavour to be part of a co-ordinated Baltic covered bond framework. There are two main elements to this:

- ensuring to the greatest extent possible that the laws are similar in three jurisdictions in all material ways. This includes the degree of credit protection that the structure provides for investors, identical asset eligibility rules and aligned administration and supervisory practices.
- Ensuring that all three covered bond laws are able to easily use assets in all three countries. To the extent that asset transfer into a Cover Pool requires enabling rules to be passed, these rules should apply to all three covered bond frameworks. That is, any changes to the (for

example) Latvian law to facilitate Latvian covered bonds should also facilitate Lithuanian and Estonian covered bonds.

Creation of Pan-Baltic market and harmonising of legislation of all 3 Baltic States is addressed in more detail in a separate document Interim Report of Introduction of Pan-Baltic Covered Bond Legal and Regulatory Framework.

3 Description of ABS and covered bonds

3.1 Definition of products and comparison

Covered bonds and securitisations are both ways in which bonds can be issued with the benefit of security interest over financial assets such as residential mortgages. There are similarities between the products in particular from a legal perspective, but also differences, in particular from an economic perspective.

The most significant differences are that a covered bond can only be issued by a credit institution (hereinafter referred to as the "bank"), has full recourse to the Issuer, is subject to Special Public Supervision and can only be backed by certain specific assets.

A securitisation can also be issued by non-banks, investors only have recourse to the underlying assets, there is no requirement under EU law for Special Public Supervision and they can be backed by any assets which are sufficiently credit-worthy and which can be legally segregated from the Issuer's balance sheet.

The differences are shown in more detail below.

	Covered bond	Securitisation
Issuing entity	According to UCITS Directive 52(4)[7] the Issuer must be a credit institution as defined in CRR article 4(1).	Typically bank but can be any legal entity
Eligible assets	Mortgages, public sector receivables, ships plus 'technical' assets including substitute security interest and derivatives – defined by Capital Requirements Directive and Regulations Typically eligible assets are defined more narrowly under national law	No legal restrictions. Any assets which can be legally identified and transferred to a Special purpose vehicle and which rating agencies and investors consider sufficiently creditworthy. In practice, frequently mortgages and consumer loan receivables
Public supervision	"Special supervisory regime to protect the interests covered bond holders" – UCITS Directive[8] Normal banking supervision and bond issuance requirements (e.g., Prospectus Directive)	No specific legislation. However, please note that the Financial Instruments Market Law will still apply to the same extent that it applies to other security issues. Thus there will be a normal supervision of Issuer – depending on legal form - and bond issuance requirements. There is no intention to adopt any special and additional rules in respect of securitization in this respect.

[7] List of laws and regulations referenced (at EU and local level) is provided in the Appendix 2.
[8] Supervisory regimes are frequently 'retrofitted' to contractually structured covered bonds – as happened in Netherlands and UK. The number of extant contractual programmes without a supervisory regime is now negligible, arguably not a covered bond at all (certainly not in any EU definition).

National legislation	Typically comprises - A covered bond act - Secondary regulations of bank supervisor - Amendments to other relevant legislation - Rules for investor treatment of securities, typically transposed from EU Directives	Jurisdiction specific. In some countries 'Securitisation Act', in others amendments to existing legislation to facilitate securitisations (e.g. amendments to tax code), in others no new material legislation is required. Contract law typically 'backbone' of structuring
EU Legislation	Exemption from bail-in under Bank Recovery and Resolution Directive Favourable investor treatment of securities under various directives Discussion of possible covered bond directive is on-going (see section 3.2)	Exemption from bail-in under Bank Recovery and Resolution Directive Less favourable investor treatment of securities under various directives Regulation for "Simple transferable Securitisations" passed into EU law January 2018. Certain regulatory technical standards currently being finalised.
Investor treatment	Lower risk weights for bank investors under capital requirements directive Lower risk weights for insurance investors, exemption from certain concentration ratios under Solvency Directive Exemptions from certain concentration ratios for investment funds under UCITS directive Eligibility for various tiers of eligible securities under Liquidity Coverage Ratio rules Eligible as security interest in open market operations of European Central Bank Eligibility for covered bond purchase programme of ECB, subject to additional criteria	Prudential regulations for securitisations that qualify under the STS rules are more favourable than those which are not STS compliant. Eligible as security in open market operations of European Central Bank Eligibility for asset-backed securities purchase programme of ECB subject to additional criteria
Typical rate and tenor	Fixed rate 3 – 20 years	Floating rate 1 – 5 years
Maturity structure	Bullet maturity. In the event of an Issuer default it is possible that some forms of covered bonds are extended ('Soft bullet' covered bonds or 'Conditional pass throughs'). These features are	Typically pass-through – the bonds amortise along with the underlying assets. Senior bonds (class A) are usually amortised before more junior ranking tranches (class B), although senior ranking

	increasingly common in newer programmes. No covered bond has ever extended. In the event of insolvency of the Cover Pool **and** of the Issuer it is possible that some covered bonds accelerate to avoid time subordination of longer dated tranches. This also has never happened.	bonds can also be tranched by order of paydown (e.g. class A-1 pay down before class A-2 but both are pari passu with each other and senior to tranche B in credit terms).
Performance during global financial crisis - credit	No defaults Downgrades usually due to downgrade of sovereign credit ratings	Mixed Securitisations backed by 'prime' assets in Europe performed well
Performance during global financial crisis – liquidity	Very good. Largely due to 'real money' investor base	Poor. Many leveraged investors forced to drastically reduce exposure to asset class
Issuer capital treatment	Capital neutral	Regulatory capital for assets can be reduced to the extent that risk is transferred to 3rd party
Inter-creditor treatment	Multiple, pari-passu, covered bonds are typically issued over time from the same programme, secured on the same pool of assets. All covered bonds rank equally. Measures are put in place in intercreditor agreements to ensure that there is no risk of 'time subordination' (longer dated bonds being de facto subordinated to shorter dated)., risk.	Bonds are typically tranched according to seniority (class A bonds are senior to class B, are senior to class C). More junior tranches pay a higher coupon, have lower credit ratings and typically, longer maturities.

3.2 EU legislative process

As part of the Capital Markets Union Initiative, directives have been developed for both instruments. Securitisations are covered in the STS Directive which provides certain preferential prudential treatment for investors in securitisation transactions that meet high quality standards. Although this directive has now been passed into EU law, several of the implementing details are subject to on-going development by both the European Banking Authority and the European Securities and Markets Authority.

Some of the key points of the directive are as follows:

- The Originator must retain some form of economic exposure to the underlying assets which equate to at least 5% of the total risk. How this risk is calculated will be defined in future technical standards but it should be noted that a similar rule in the US allows multiple ways in which Originators can interpret the 5% value.

- Investors must undertake due diligence to ensure, inter alia, that the information that they will receive is sufficient, that they understand the structure of the securitisation and that they have sufficient risk management processes and controls in place.
- There must be a high standard of transparency with regard to deal documentation, the historic performance of comparable assets and the quality of the underlying assets disclosed on an at least quarterly basis. This should be independently audited to a high degree of confidence and a cashflow model of the transaction should be made available.

Certain national supervisory minimum standards are set to ensure that the securitisations conform to the directive, that all risks associated with the securitisation for the Issuer are addressed and that there are sufficient legal remedies available in case of a breach. It should be noted that this differs significantly from the supervisory standards for covered bonds in particular to the extent that covered bond supervisory standards include a 'duty of care' towards the investors under the UCITS Directive, article 52(4).

Covered bonds are defined in national law. However, European Union law refers to them in two ways. Firstly, it provides certain exemptions which facilitate the structuring of covered bonds, namely, an exemption from bail-in under the bank recovery and resolution directive and an exemption from clearing obligations for associated derivative transactions under EMIR. Secondly, they specify the treatment for qualifying covered bonds for certain classes of investors including, their treatment under concentration limits for asset managers under UCITS, their capital consumption for insurers under Solvency 2 and their capital consumption and liquidity categorisation for Liquidity Buffer purposes for bank investors under the capital requirements regulations and associated delegated acts.

The European Commission in March 2018 published a draft directive and amendments to certain regulations for covered bonds. It is the intention to pass this directive in the current parliamentary term subject to agreement with Council and Parliament. The process of agreeing a final draft is currently on-going, however, most of the points currently under discussion are of little relevance to the current project.

The draft directive sets down certain minimum standards for covered bonds in order to qualify for preferential prudential treatment. In particular it specifies:

- Necessary structural features of covered bonds (such as the requirements for dual recourse, bankruptcy remoteness), the eligible assets to back the bonds (including derivatives and substitution assets), rules governing key parties to the transaction such as the Cover Pool Monitor, over-collateralisation and liquidity requirements.
- The features required of the supervisory regime for covered bonds, including the licensing of Issuers and the treatment of the bonds in resolution or insolvency.
- Quality protection measures and minimum criteria in order to benefit from a preferential risk weighting for the bonds by bank investors.

In addition to their legal treatment, covered bonds have been purchased by the national central banks of the Eurosystem far more frequently than securitisations. This has taken the form of three covered bond purchase programmes, the latter as a part of the quantitative easing programme. The current asset purchase programme includes ABS purchases. Covered bonds and ABSs are also widely used as security in open market operations of the Eurosystem.

In the absence of a covered bond market in Latvia the purchase programme has been unable to operate there. There is therefore substantial 'pent up' demand for Latvian covered bonds from the Euro central bank system.

3.3 Status of the project in Lithuania and Estonia

Estonia

The Estonian Ministry of Finance announced in January 2016 that they were working on developing a covered bond law. A draft of this was published for initial public consultation in March 2018 and was submitted to the Parliament in November 2018. The draft law is expected to be adopted by the Parliament in February 2019. The draft law is based on work undertaken before the launch of the pan-Baltic framework initiative.

The EBRD has provided comments on the draft covered bond law and met the Ministry of Finance and other stakeholders to discuss the comments. These comments reflect i) aspects of the draft law which should be made compatible with the pan-Baltic framework, ii) the implications of the proposed covered bond directive and iii) certain commercial and technical aspects of the law to improve its effectiveness. The Ministry of Finance is considering amending the law after its adoption based on those comments.

Lithuania

The draft Law on Securitisation and Covered Bonds has been drafted and registered at the Parliament on the 19th of July, 2018. The public consultations have been performed and currently the draft law is being adjusted according to the remarks received from the market participants.

3.4 Benefits and risks of ABS

To the extent that the credit rating of a securitisation can be totally delinked from that of the Issuer they can achieve a very low cost of financing whilst at the same time accurately matching the maturity profile of the assets to that of their funding.

The costs of funds argument is particularly relevant for non-bank Issuers who do not have access to cheaper deposit, short term or central bank funding facilities that banks normally benefit from (subject to eligibility criteria).

Whilst there is increasingly a regulatory requirement for the Issuer to maintain some exposure to the riskiness of the underlying assets, securitisation can be used to limit that exposure and reduce catastrophic downside risks in the banking system. This risk mitigation aspect of the instrument is reflected in the possibility to reduce regulatory capital requirements for the assets securitised.

From a theoretical perspective it is optimal for the risks and returns of assets to be allocated to the economic player who is best suited to own these risks and returns which is not necessarily the bank which originated them.

Even with a requirement to retain some form of economic exposure to the underlying assets there is a moral hazard risk inherent in the instrument to the extent that the entity responsible for the origination and servicing of the assets is not fully exposed to their risk.

Historically the investor base for securitisation has been highly leveraged – investors who borrow in the capital markets in order to be able to invest - and, as such its capacity to buy securities fell significantly during the financial crisis introducing price volatility and precluding refinancing. The highly leveraged investors are no longer a significant part of the securitisation buyer base.

Most of the downside risks that have historically been associated with securitisations are mitigated by the European Union's STS directive-(see section 3.2).

From the perspective of the borrower whose loan is included in the pool certain safeguards should be put in place in a securitisation structure to ensure that their inclusion in the pool is in no way detrimental to their consumer rights. Of particular note are:

- Their rights to banking secrecy;
- Their ability to set-off amounts which they owe the bank against deposits which they have with them in the event of the bank's failure. The European Union guarantees of retail deposits significantly ameliorates this problem;
- Their rights to amend contracts, for example to request a new mortgage product;
- Their rights under the Mortgage Credit Directive, in particular their right 'reasonable forbearance' in the event of financial stress.

Specific benefits to the Latvian economy of a functioning ABS market include:

- reducing the volatility of funding availability for corporates in a crisis either by direct issues of securitisations of eligible assets by corporates or by facilitating more stable funding of corporate loans for banks;
- providing a means for Latvian banks to reduce the potential for extreme downside losses associated with their exposure to a narrow pool of highly correlated assets;
- diversifying the set of domestic assets available to fixed income investors from its current relatively low base.

3.5 Benefits and risks of covered bonds

By virtue of their enhanced soundness covered bonds achieve a significantly higher credit rating than the entity which issues them. This can theoretically be of the order of 8 notches of rating uplift although in practice this is often constrained by the maximum rating achievable in any given country and/or by the AAA upper bound to ratings.

Given the rating uplift and the preferential treatment that covered bonds attract for EU based investors, they can be issued at a significantly lower interest cost than unsecured debt, for longer maturities enhancing funding stability and improving asset and liability duration matching and can be issued in periods of extreme volatility when other bond markets may not be available.

The discipline of a detailed rating agency and supervisory review of the assets in the Cover Pool and the alignment of interests between the Issuer and covered bond investors both requires and rewards the origination of safe, high quality assets for inclusion in Cover Pools.

From the perspective of investors, covered bonds provide a highly rated, liquid alternative to investing in government securities, thus reducing the credit nexus between the banking and public sectors. This is of particular significance for bank treasury investors who are required to maintain buffers of liquid assets under the LCR (Liquidity Cover Ratio) regulations. Covered bonds are allowed as Tier 1 assets for the purposes of these regulations alongside public sector securities.

Perceived risks of covered bonds are generally two-fold.

As with securitisations (see above), it is important that the inclusion of a mortgage in the Cover Pool in no way impairs the rights of the mortgage borrower, including their rights to banking secrecy, to negotiate new banking products and to benefit from consumer protection law. Safeguards must be put in place to ensure that no borrower is worse off as a result of their inclusion in the Cover Pool.

The ring-fencing of assets for the benefit of one class of creditors potentially creates a degree of subordination for unsecured creditors. Furthermore it reduces the stock of high quality mortgage assets that can, for example, be used as security for emergency funding facilities provided by the central bank

In some jurisdictions this risk is addressed by limits on the number of covered bonds that can be issued as a percentage of total asset on balance sheet, a requirement for a certain minimum level of high quality unencumbered security, or an incremental capital charge for excessive encumbrance. All of which mitigants could be calibrated to the riskiness of the Issuer (for example, well capitalised Issuers may issue more covered bonds before attracting an incremental capital charge).

Specifically in a Latvian context, the introduction of a functioning covered bond market will increase the stability of the financial system by reducing the current heavy reliance on short term deposits and enable Latvian banks to fund themselves independently from their non-Latvian parent companies.

3.6 Synthetic securitisations

All of the above comments relate to 'traditional' securitisations whereby assets are transferred to an SPV which pays for these assets by issuing bonds. A related instrument is known as synthetic securitisations.

Typically in a synthetic securitisation the credit risk of the assets is transferred to a Special purpose vehicle (SPV). A synthetic securitisation typically involves a credit default swap contract, under which a swap counterparty agrees to cover the losses suffered by the owner of the reference assets (usually the Originator) if a credit event (usually a non-payment) occurs with respect to the reference assets. In return, the owner of the assets agrees to pay the swap counterparty premiums based on the perceived probability of credit events occurring.

The Special purpose vehicle off-sets the risk most often by issuing bonds to third party investors the notional of which is written down if losses occur on the underlying asset pool. The SPV then uses the proceeds of this bond issue to purchase high quality security which it will sell in the event that it needs to make a payment to the bank under the indemnity.

Synthetic securitisations are governed by bi-lateral contracts between the parties rather than by an act of parliament. Furthermore they are only used for risk capital mitigation purposes, not to provide financing for the banks. As such we have excluded them from the scope of the current project.

3.7 European Secured Notes

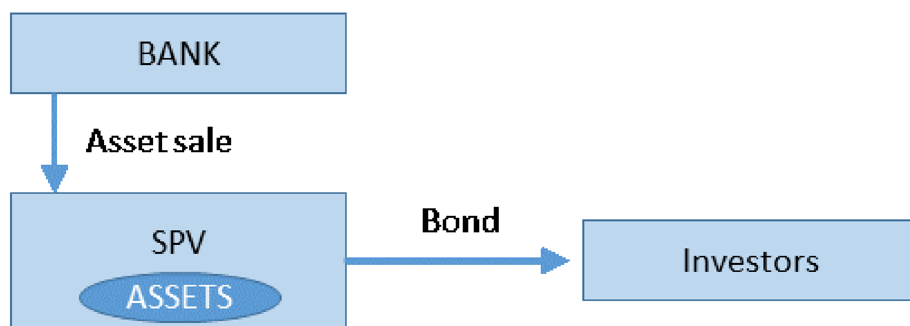
The European Commission is currently investigating the possibility of introducing legislation for 'European Secured Notes' – securities which apply covered bond technology to other asset classes such as loans to small and medium sized enterprises and bank infrastructure loans. It is possible that legislation on this topic could be introduced to the covered bond directive as part of the trilogue process currently ongoing. Alternatively legislation may be introduced in the next European Parliamentary session.

If this concept is introduced into the current legislative process we will assess the market appetite for adding it to Latvian law and pan-Baltic framework.

4 Overview of the ABS and covered bonds structures and features

4.1 ABS structures

In the vast majority of cases (other than synthetic securitisations, see section 3.6) securitisations are structured as per the below diagram. The bank which originated the assets transfers them in some way (the diagram has shown asset sale, this is a simplification which will be discussed below) to a newly established legal entity (Special Purpose Vehicle or SPV) which funds the transfer via the sale of notes to investors. These notes are secured on the underlying assets and the notional and interest payments on these notes will depend on the assets paying down.



4.2 Covered bond structures

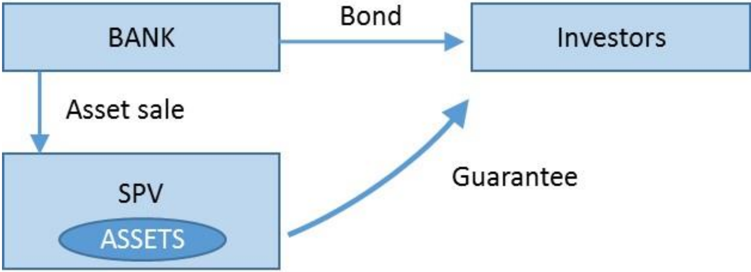
> We recommend that the Separate Guarantor model (section 4.2.1) is adopted in Latvia:
>
> – due to the substantial synergies that exist between a securitisation and covered bond law,
> – due to the high degree of legal certainty which can be generated,
> – this model requires less amendments to Latvian insolvency regulation and is more compatible with the regulation currently in force, and
> – because this model facilitates at once the asset transfer within Latvia as well as on the Pan-Baltic level.

Covered bonds are typically structured in one of four ways. All of these alternatives are widely used, accepted by investors, compatible with EU law and the recommendations of the European Banking Authority and achieve a similar degree of credit protection for investors. The choice of which alternative to adopt is typically based on practical legal and commercial considerations in any given jurisdiction.

Two of these models were in detail considered for introducing in Latvia (the other two were ruled out instantly as impracticable for implementing in Latvian market and legal system).

The two types are as follows.

4.2.1 Separate Guarantor model (“SPV”)



Used in (for example): UK, Netherlands, Italy

Bonds are issued by a bank which at the same time transfers a pool of assets to a separate legal entity (a ‘Special purpose vehicle’ or ‘SPV’). The SPV issues a guarantee of the bonds issued secured on the assets that have been transferred to it. The Issuer is obliged to buy-back impaired or ineligible assets and replace them with suitable assets on a revolving basis to ensure that the SPV is able to meet any obligations under the guarantee. The SPV is consolidated with the Issuer for accounting and regulatory purposes but not in insolvency.

This structure requires the transfer of the assets to the SPV at inception which might be quite onerous, because effecting of the transfer of mortgages requires their re-registration with the respective land registries, which results in administrative burden as well as costs (including notaries fees). In order to avoid this, amendments of the current regulation to ensure efficient re-registration would be needed, which will require financial resources from the state, as well as political will to change the current system.

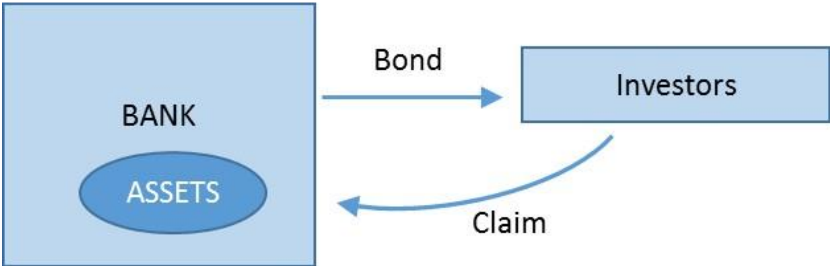
On the other hand, this structure achieves a very high degree of legal certainty. As the assets are transferred to the SPV before they are needed (that is before an insolvency of the bank) there is no possibility that the assets can be in anyway impaired by the insolvency or resolution of the bank, provided that the transfer is correctly legally structured.

No specific insolvency legislation is needed. In the On-Balance sheet model, described below, amendments to insolvency regimes are typically extensive and onerous.

Furthermore, the SPV as a distinct legal entity already existing is able to enter into contracts, for example to refinance or hedge the assets with third parties without the consent of the insolvency court or the establishment of a ‘legal personality’ for the Cover Pool.

This structure contains many legal similarities with securitisations and is frequently seen in countries where both financing tools are used in order to reduce unnecessary amendments to existing laws.

4.2.2 On-Balance Sheet model (“OBS”)



Used in (for example): Germany, Spain

Bonds are issued by a bank which at the same time designates a pool of assets to serve as security for that issue in the event that the Issuer defaults or enters resolution. The Issuer is obliged to maintain

the pool of assets on a revolving basis to ensure that it provides adequate protection for covered bond investors.

This is structurally straightforward as the assets do not need to be transferred to a third party at inception but requires substantial legal technology to ensure that:

- the claim of the covered bond creditors survives the insolvency or resolution of the Issuer,
- that other creditors cannot establish a claim against these assets,
- that normal bankruptcy procedures such as a stay on payments or the exercise of claims can be set aside and that the pool and associated liabilities can be transferred to a third party if required.

All of which require extensive additional legal changes to be introduced with costs, risks that they do not achieve the desired aim in practice and potential unintended consequences.

However, the asset transfer within this model might be less complicated than in the SPV model, as the assets are 'transferred' within one legal entity, thus, no re-registration of the mortgages with the land registries (or no amendments to laws regulating the re-registration) are needed.

4.2.3 Interest accrual after insolvency – comparison of SPV and OBS models

At the moment of insolvency of the issuing bank the bonds cease to be obligations of the insolvent bank and become obligations of the pool of assets which upon banks insolvency becomes a distinct entity from the insolvent bank (in the OBS model) or become obligations of SPV which at that point in time is already a distinct entity (in the SPV model).

Provided that the asset pool and SPV remain solvent, the bonds will continue to accrue interest as normal. This means that the payments to the bond holders will be made in accordance with the original payment schedule for principal and interest. At the same time a claim against the insolvent bank estate is created. This claim ranks *pari passu* with the claims of other unsecured creditors of the insolvent bank (although it is exempt from bail-in provisions under article 44 of the Bank Recovery and Resolution Directive therefore it is *pari passu* with, strictly speaking, senior preferred creditors). The claim is equal to all principal and interest due under the bonds and is immediately accelerated, but does not accrue interest from that date (thus ensuring equality of interest with other creditors of the bank).

Although the claim against the Issuer is accelerated, payments under the bonds are not accelerated until the asset pool (in the OBS model) or the SPV (in the SPV model) itself is insolvent. If the asset pool or the SPV becomes insolvent, then all creditors' claims of the asset pool or SPV would accelerate and rank *pari passu* with one another. The matter how the insolvent asset pool or SPV satisfies all these creditor claims (in particular with regard to avoiding a time-subordination of longer dated bonds to shorter dated ones) is typically defined under contract law. For example, rules may be put in place whereby before a bond is paid down, a test is run to ensure that there will still be sufficient performing assets to ensure that other, longer dated bonds will still have sufficient assets available to them. If this test is breached, all of the remaining tranches of bonds may cross-accelerate (and become immediately due and payable on a *pari passu* basis). Alternatively, they may continue with their existing schedule and the bond that has reached it's expected maturity date may be extended and paid down on a pass through basis from a part of the asset pool equal to that bond's proportion of the total bonds outstanding. These details are decided by the Issuer in discussion with rating agencies and are documented under contract law. Due to their commercial and technical nature it is generally not considered appropriate for these details to be defined in law.

4.2.4 Consideration of dual approach

It would be possible to adopt legislation allowing the banks to choose between use of the OBS model and SPV model at the issue of covered bonds, , however we do not believe that this would be appropriate for the reasons outlined in this section.

There are some countries in Europe which allow more than one model to be adopted:

- In some countries these have developed over time for different types of issuer, for example in Austria there are three separate structures allowed, one adopted in 1899, one in 1905 and the most recent in 1927. However this is considered to be sub-optimal and there is an on-going effort to remove this distinction "with the aim of further harmonising/unifying legislation". In France also multiple models exist although this is not considered a cause for concern, partly as the market there is all three models available are liquid and are considered to have critical mass.
- Furthermore, in Greece both OBS and SPV models are allowed, however only SPV based covered bonds have ever been used in practice.

Whilst the adoption of two models would give banks a choice of model OBS or SPV, still we consider that it would also present certain problems:

- <u>Signal to investors</u>. Given the relatively small potential market size of Latvian covered bonds, investor willingness to undertake the (often substantial) credit and legal analysis of more than one model might be limited. Furthermore, to the extent that the models are considered to create two 'sub-markets', investors may consider this to be detrimental to secondary market liquidity.
- <u>Drafting complications.</u> As several existing pieces of legislation will need to be amended, in particular for the on-balance sheet model which will require the creation of new legal technology such as ring-fencing, the co-operation of multiple stakeholders will be needed. There is a risk that this will be less forthcoming if stakeholders perceive that the amendments are not needed due to the parallel development of an equally workable covered bond framework without the need for that specific amendment.
- <u>Time to develop</u>. Clearly drafting two models in parallel will be more time consuming than the development of one, exacerbating the already likely gap between the implementation of the covered bond law and the implementation of those in Lithuania and Estonia.

4.2.5 Comparison of SPV and OBS models

4.2.5.1 Financial accounting

SPV is a controlled subsidiary of issuer in the definition used in IAS27, therefore financial reporting must be undertaken on a consolidated basis with intra-group exposures netted to zero.

Therefore accounting treatment is identical in OBS and SPV models.

4.2.5.2 Regulatory reporting and regulatory capital

SPV is consolidated for prudential purposes according to Article 18(1) of Capital Requirements Regulations (EU 757/2013).

All covered bond regulations currently in place meet the criteria for this consolidation.

The regulatory reporting and capital are identical between the two models.

4.2.5.3 Taxation

Both OBS and SPV models achieve 'tax neutrality' in all existing covered bond models, that is the tax treatment is substantially identical to tax treatment of regular bond issue.

In other jurisdictions SPV model's 'tax neutrality' is achieved by:

- the SPV and the issuer being consolidated for taxation purposes (so transactions between the two net to zero) and/or
- the SPV's cashflows being such that there is no profit generated (assets are bought and sold or repaid at par value, interest flows on the assets definitively equate to interest flows on the loans to the SPV).

In some jurisdictions the SPV is required to generate a token profit which is taxable, for example, one basis point. This has a negligible impact on overall costs.

In SPV model the bank is acting as an agent for SPV for which it receives a small fee, but as this is paid to the bank owning the SPV, then there is potentially no net impact, if the taxes are calculated on a consolidated basis.

In order to achieve 'tax neutrality' for SPV model, the following 3 solutions can be considered:

- the SPV and the bank are consolidated and treated as one entity for taxation purposes (Latvian law is aligned with the laws of some other jurisdictions having an SPV model);
- the SPVs are not considered corporate income tax payers (corporate income tax is paid at the level of the bank) and transfer pricing is not applicable in transactions between the bank and the SPVs;
- the SPV's cashflows being such that there is no profit generated (please see above) and assets are transferred at market value therefore there are no transfer pricing implications for transactions between the bank and the SPVs.

Please note that these options are being discussed with the Ministry of Finance and we propose to implement the 2nd solution – the SPVs are not considered corporate income tax payers (corporate income tax is paid at the level of the bank) and transfer pricing is not applicable in transactions between the bank and the SPVs. If the 2nd solution is rejected and fails, then the next viable alternative is the 3rd solution.

4.2.5.4 Supervision

The responsibilities of supervisory authorities to covered bonds are detailed in EBA Best Practice recommendations 7-b and 7-c and in articles 18 – 20 of the (draft) covered bond directive. These detail the main tasks required including licensing and authorisation, stress testing, ongoing supervision and responsibilities post-insolvency. None of these tasks are in any way influenced by the choice of model.

4.2.5.5 Operational considerations

In both models (SPV and OBS) the bank continues to manage the mortgages as currently and mortgage re-registration is done only at the issuing bank's insolvency. In 'business as usual', (that is, prior to the insolvency of the bank) in the event that an individual mortgage in the cover pool has to be enforced it is removed from the cover pool and bank will exercise its security in its own right.

According to the most recent discussions, the Ministry of Justice as a general rule accepts such approach, subject to further development of details and technical solutions.

In practice, the SPV will not have any employees and there will be only a small number of tasks that have to be done by the SPV. The most notable task would be generation of the reports regarding the cover pool (which in essence would be identical regardless whether SPV or OBS model is in place).

In SPV model the bank is acting as an agent for SPV for which it receives a small fee due to the small amount of task performed for the SPV, but as this is paid to the bank owning the SPV, then there is potentially no net impact, if the taxes are calculated on a consolidated basis. These agreements will typically be governed by a relatively standard 'off the shelf' agreements between SPV and issuer.

In both SPV and OBS models bank will be required to regularly generate reports of the assets in the pool, this will be sent to the cover pool monitor and regulator.

4.2.5.6 Separate account

Whether the Cover Pool is in a separate SPV or on balance sheet it will need to be able to identify and hold in its own bank account the funds associated with the underlying assets, including interest and principal, reserve accounts and 180 day liquidity accounts. Typically the SPV's bank accounts will be held with the issuing bank until such time that the issuing bank's credit rating is considered inadequate by the rating agencies (for example at loss of a BBB- rating), at which time the bank accounts will need to be transferred to a third party bank.

4.2.5.7 IT requirements

The information technology required, for example, to maintain management information systems and regulatory accounts in both OBS and SPV models is broadly similar.

In the 'business as usual' case, it will be necessary to undertake the following main areas:

- Identifying the cover pool. This will include being able to identify and select eligible assets to be added to the Cover Pool and ineligible assets to be removed from the Cover Pool, the creation of information reports on the underlying Cover Pool for the benefit of investors, supervisors, the Cover Pool monitors and rating agencies and the creation of a list of assets in the pool from time to time for the purposes of identifying the assets which are transferred (SPV model) or which are ringfenced (on OBS model). This function is essentially identical in the two models.
- Accounting for the transaction, including the appropriate accounting entries for the bond itself and for the 'notes to accounts' identifying the assets pledged (OBS model) or the SPV's consolidation.
- Accounting for the SPV. In the case of the SPV model the accounts of the SPV will need to be generated for statutory reporting purposes. This is a straightforward exercise given the simplicity of the SPV's cashflows.

After the insolvency of the bank, the IT requirements for the Cover Pool will be more extensive – reflecting the inability of the Cover Pool to rely on the bank to perform the necessary functions. In addition, the requirements will identical regardless whether OBS model or SPV model is chosen, as it would have to address the Cover Pool's 'orphan' status after bank's insolvency. It will be necessary to demonstrate *ex ante* that IT procedures are in place and can be separated from the issuing bank, for example, demonstrating that the cover pool post separation / SPV has the necessary software licenses in place to manage the underlying assets.

4.2.5.8 Additional costs of SPV model

There is a small additional cost associated with the establishment and management of the SPV. For straight forward and simple SPV setup, by way of example, the establishment fees EUR 300 – 700, legal address service EUR 25-50 per month, annual report EUR 100.

The SPV will have no employees and will have no day to day operations – these remaining with the issuing bank - and that SPV's audit is part of the existing audit procedures of the bank. It will be necessary for rating agency purposes to demonstrate that no activities which could give rise to material claims against SPV can be conducted by SPV – for example, employing staff.

4.2.5.9 Use of assets of Latvian branches of EEA banks

The selection of SPV or OBS model in Latvia does not affect bank's ability to use Latvian assets of branch in its covered bond program. The limitations and problems related to the use of the assets will exist regardless which model is chosen in Latvia, as these issues are not dealt with by the model. The solution to this matter requires to put in place mechanisms that allow banks to use Latvian assets of branch, as well as these mechanisms should accommodate the possibility to use assets of subsidiary banks or sister banks. These mechanisms might require adjustment of the current legal framework and more detailed analysis should be performed.

4.2.6 SPV model advantages in comparison to On-Balance sheet model

Covered bonds can be structured in various ways, the most prevalent two models are the On-Balance sheet model (described in section 4.2.1.), where assets are ringfenced for the benefit of creditors, but continue to be owned by the originating bank until such time as they need to be segregated, typically in insolvency and the SPV model (described in section 4.2.2) where assets are transferred to a separate legal entity which guarantees the bonds issued by the bank. The legal entity is separate only for the purposes of non-consolidation in insolvency and for all practical purposes is treated as the same entity as the Issuer.

Both models are used frequently in other jurisdictions and both are fully accepted by investors and rating agencies alike without any preference. As a generalisation the On-Balance sheet model tends to be used in countries with older covered bond regimes whilst the SPV model has been the preferred choice for new jurisdictions. Having said that Estonia is developing an On-Balance sheet model whilst Lithuania is using an SPV model.

If structured correctly there are no material cost, regulatory or operational implications for the Issuer of the choice of model.

We recommend the adoption of an SPV model in Latvia for the below reasons, more fully expanded in this memo:

- Greater legal certainty. SPV model uses existing legal technology to segregate assets. OBS model would have to develop new legal technology, we have identified the following problematic areas:
  - **Ringfencing of assets on balance sheet**

    Although there are similar precedents in Latvia regarding segregation of assets of pension plans and most recent amendments in the Credit Institutions Law on segregation of assets used for mortgage notes in case of bank's insolvency, nevertheless there is no well-established legal doctrine and case law about asset ringfencing . Legal certainty of creditors claim is essential for a good investor reception for the bonds. The practice has shown that in OBS structures there can be rules that at the adoption of law seems acceptable, but during the practical implementation turn out to be problematic. Hence the law firms and rating agencies are scrutinizing legal regime in much more detail and might be more cautious with their evaluations and legal opinions. As a general rule, this is not a major issue for countries with well-established legal traditions of OBS models where all the persons involved understand the OBS model and its functionality. However, for countries only developing its covered bond traditions SPV is a safer option.

  - **Amendments to law implementing Bank Recovery and Resolution Directive**

    This law will need to be amended to exclude covered bond assets and liabilities from the scope of the resolution powers. The ringfencing required for the purposes of

insolvency (previous point), is not adequate for the purposes of ringfencing assets in resolution.

- **Transactions with self**

  Cover Pool will require derivatives to, for example, manage interest rate risks, so that the bonds interest/coupon payments can be fixed while the underlying mortgage assets' interest payments may be floating (i.e. charged at a spread over the originator bank's standard-variable rate). In SPV model these derivatives are between SPV and issuer. For OBS model new technology would need to be developed to allow issuer to enter into derivative with itself (same legal entity), or if this proves impossible, issuers will need to obtain swaps from third parties. If 3rd party swaps are used, swap counterparties will need to negotiate separate ISDA masters agreement for Cover Pool and 'regular' swaps and netting between the two must be disallowed. This may be commercially problematic for counterparties.

- **Protection of bond holder interests**

  In SPV model, directors of SPV are replaced by independent directors in insolvency to ensure actions are undertaken in best interests of bondholders. In OBS model a mechanism must be designed between insolvency court, administrator and regulator to achieve the same outcome.

- Compatibility with securitisation law.

In this chapter we also discuss the operational and cost requirements of both models and as table below show the models adopted in various jurisdictions recently.

Model used in recent covered bond jurisdictions[9]

2003[10]	UK	SPV
2007	Norway	Special Bank
2007	Holland	SPV
2007	Turkey	On b/s
2008	Greece	Either
2008	Canada	SPV

[9] In France and Switzerland the above table refers to the most recent covered bond model. In France the 'Special Bank' model has been used for some time, in Switzerland the 'agency' model was used since the 1930s. In both cases the introduction of the new model was for commercial reasons given the inadequacy of the existing model. In France the model (societe de financement de l'habitat) is between the Special Bank model and the SPV model. The 'SPV' (for example 'BNP Paribas Home Loans SF') buys the assets from the parent entity ('BNP') as with an SPV but is the issuer of the bonds, rather than their guarantor (as with a Special Bank model). In Greece either model is allowed but historically programmes have used the SPV model. This may change in the future

[10] Date of market establishment

2008	Italy	SPV
2009	Switzerland	SPV
2010	New Zealand	SPV
2011	Cyprus	On b/s
2011	Australia	SPV
2012	Belgium	On b/s
2012	Panama	SPV
2013	France	SPV
2015	Singapore	SPV

4.2.6.1 Legal considerations

The SPV model requires broadly existing legal technology for the creation of the legal entity, the sale of the assets, the transactions that the SPV must enter into and other features. The main areas that require new legal technology include the exemption of the SPV from thin capitalisation rules and the ability to transfer assets to a new owner, including for example the recording of security interests.

All of the technology that must be developed for the SPV model must also be developed for the on balance sheet model as, in the event of Issuer insolvency under that model, the Cover Pool will need to be legally segregated from the insolvent bank and acquire its own legal identity.

The On-Balance sheet model, in contrast requires several new legal concepts to be developed, in particular:

- The assets must be ringfenced from the other assets owned by the bank. This ringfence must be sufficiently robust to survive claims of unsecured creditors in an insolvency, limit the powers of the resolution authority over the assets and extinguish rights of set-off (which would usually exist for retail borrowers as they have their mortgage and cash deposits with the same legal entity).

  This segregation must apply to all of the assets in the Cover Pool from time to time, not just those required to meet the Issuer's obligations to maintain certain levels of over-collateralisation. There has been uncertainty expressed by some investors about whether their claim includes all of the assets, for example, in Germany the insolvency court is required to release from the Cover Pool 'assets not obviously needed' to cover the claims of covered bond creditors. In the SPV model there is no doubt about the claim on the entire Cover Pool. In a nutshell, at this point of time Latvian law does not have examples of ringfencing certain part of company's own assets within the company itself in case of this company's insolvency. The closes resembling example is holding of clients' financial instruments and money as of balance sheet items by commercial banks. As a general insolvency rule the assets belonging to third parties are outside the insolvency estate; however, then that third party must provide evidence proving the ownership title over respective assets.

- The Cover Pool will need to enter into some legal transactions including derivatives (which swap the rate received on the mortgages with the rate required on the bonds). In the SPV model this is typically entered into between SPV and issuing bank in a normal way. In the on balance sheet model the Issuer effectively has to enter into a transaction with itself (one leg of the swap in the Cover Pool, one outside). Latvian law does not provide possibility to enter into transactions with yourself. This would be considered as a "legal fiction".]

  If the Cover Pool enters into swaps with third parties these will need to be documented under a separate ISDA master agreement from any other swaps that the issuing bank happens to have with that third party. The third party will be required to relinquish their rights to net the exposure under the two swaps in insolvency. This is often problematic commercially and in case of Latvia also poses a legal issue.

- In the SPV model the SPV is controlled by a board of directors. In the event of the issuing bank's insolvency, independent directors are appointed who act in the best interest of the covered bond holders. There is no equivalent body under the On-Balance sheet model. Therefore, commercial decisions must be made by a newly appointed body, most typically this is a combination of a Special Administrator, the FSA and the insolvency court.

In some countries the SPV model is preferred as a sale of assets is permissible under negative pledge clauses whilst the creation of security interest within a ring fence on balance sheet is not.

4.2.6.2 Compatibility with securitisations

Securitisations, although economically very different from covered bonds, involve many of the same legal issues as the SPV model of covered bonds – in particular the establishment of the entity, its exemption from thin capitalisation rules, the transfer of the assets and the interaction between the SPV and the bank.

We believe that there is a potential role for securitisations in Latvia either for, i) banks funding assets not eligible for covered bonds, such as loans to small businesses, ii) banks attempting to achieve reduced regulatory capital against assets that are eligible for covered bonds, such as residential mortgages, or iii) for non-bank lenders.

As such there is a significant potential synergy between the two products in terms of both the drafting of the law and, in future, in the drafting of documents to govern the transactions.

4.2.6.3 Operational and cost considerations

From an operational perspective the two models are largely identical. Issuing banks will need to periodically generate a list of assets in the Cover Pool, most likely monthly.

In the On-Balance sheet model this list is transferred to the FSA as a record to be used in the event that the ring-fence needs to be enforced. In that eventuality they will also need to re-register the security interests in the assets at the Land Registry to the new Cover Pool's new legal identity.

In the SPV model the reporting requirements are similar, the list should be sent to the financial supervisor and the Land Registry. The Land Registry will only action this list and enter a note of the beneficiary of the security interest on each individual property in the event that it is needed, that is, insolvency of the Issuer.

The one additional cost of the SPV model is the establishment and management of the entity. As the SPV will be exempt from thin capitalisation rules it will be capitalised with € 2,800. The corporate filings and reports of the company would also be very straightforward: the SPV only has four cashflows per period (receives: payment from mortgages and payment under swap, pays: loan from parent and

payment under other leg of the swap). In general, these might be accounting and auditing costs (as the report filing to the State Revenue Service is free of charge).

Usually the SPV generates no profit as all of it's cashflows match.

4.2.7 Choice of covered bond structure, considering the Pan-Baltic aspect

Essentially the same considerations as above apply for the each of the models, if considering the pan-Baltic asset transfer. Namely, if banks, which operate in two or all of the Baltic states as separate legal entities or as a single entity, wish to establish a pan-Baltic Cover Pool.

However, in pan-Baltic asset transfer scenario the complications for effecting the transfer (the re-registration of mortgages) are relevant in both the separate guarantor model as well as the On-Balance sheet model. If a bank, which operates under the same brand, but has separate legal entities in two or all of the Baltic states, wishes to establish a single pan-Baltic Cover Pool, then it must transfer the assets from one legal entity to another even if the On-Balance sheet model is used. Hence, the security securing the transferred loans would need to be transferred and under the current legislation – re-registered with the public registries.

The SPV model, where the asset transfer is required, already in the initial setup addresses the legal issues related to the asset transfer within Latvia as well as the same rules for asset transfer can be applied to assets transferred on the Pan-Baltic level, including in case assets are transferred from a country that has implemented the On-Balance sheet model. In comparison to the On-Balance sheet model where additional legal regulations should be introduced, because the Cover Pool should not be only segregated from other bank's assets (local relevance), but also those assets received from other Baltic commercial banks should be identified as a part of Cover Pool, including reregistration of security interests might need to take place for Pan-Baltic level transfers. Please see below the summary table indicating which issues are relevant for each On-Balance sheet model and Guarantor model.

_"**X**" means an issue, which should be addressed
"**–**" means that no issues, which should be addressed, have been identified.

Aspects creating issues under the current regulation	Locally relevant		Pan-Baltic relevant		Need to analysed at further law drafting stages whether amendments needed: carve-outs from and/or references to
	SPV	OBS	SPV	OBS	
1. Establishing of Cover Pool					
1.1. Ensuring Cover Pool's independence from bank's management	X	X	X	X	Credit Institutions Law Commercial Law
1.2. Asset transfers between the bank and the Cover Pool are not considered as "transactions between related parties"	X	-	X	-	Commercial Law
1.3. No additional licences needed (consumer credit, debt collationer's	X	-	X	X	Consumer Rights Protection Law

Aspects creating issues under the current regulation	Locally relevant		Pan-Baltic relevant		Need to analysed at further law drafting stages whether amendments needed: carve-outs from and/or references to
	SPV	OBS	SPV	OBS	
etc.) and no other additional regulatory requirements apply					Law on Extrajudicial Recovery of Debt
2. Asset transfer					
2.1. All assets are transferred ("true sale")	X	-	X	X	Civil Law
2.2. Asset transfer cannot be challenged by the underlying loan borrowers, guarantors and other affected persons	X	-	X	X	Credit Institutions Law Insolvency Law Civil Law
2.3. Simplified security registration procedure (mortgages with land registry can be registered by one application, and asset transfer can be reversed asset-by-asset or by bulks when needed or alternatively as proposed in section 5.3.3)	X	-	X	X	Land Registries Law Notaries Law Commercial Pledge Law
2.4. Notification to the borrower	X	-	X	X	Credit Institutions Law
2.5. No effect on borrowers' contractual rights	X	-	X	X	Civil law
2.6. No effect on borrowers' statutory rights - consumer and personal data protection, bank secrecy	X	-	X	X	Consumer Rights Protection Law Data Protection Law Credit Institutions Law
2.7. Transfer extinguishes borrower's set-off of rights against the original lender in case of the bank's insolvency[11]	X	-	X	X	Credit Institutions Law
3. Bank's insolvency / resolution management					

[11] The stakeholders have asked for additional analysis on whether set-off should be preserved.

Aspects creating issues under the current regulation	Locally relevant		Pan-Baltic relevant		Need to analysed at further law drafting stages whether amendments needed: carve-outs from and/or references to
	SPV	OBS	SPV	OBS	
3.1. Bank's insolvency does not accelerate the obligations related to the covered bonds	X	X	X	X	
3.2. Cover Pool is not a group company (not consolidated) with the bank in insolvency or resolution	X	-	X	-	Credit Institutions Law Law on Bank Resolution and Recovery Insolvency Law
3.3. Ring-fencing of the assets (separation of bank's assets and Cover Pool's assets)	-	X	-	X	
3.4. Claims of bond creditors survive insolvency or resolution of bank	-	X	-	X	
3.5. No control of the Cover Pool's assets in the Issuer's insolvency or resolution by bank's creditors or administrator or liquidator, or resolution authority	-	X	-	X	
3.6. Insolvency procedures – stay on payments and transactions - do not freeze the operation of the Cover Pool	-	X	-	X	
3.7. The asset transfer cannot be challenged by the Cover Pool's creditors (and bank's unsecured creditors) in case of bank's insolvency or resolution	X	-	X	X	
4. Tax and payment neutrality					
4.1. No (or minimised) land registries'stamp duty for transfer	X	-	X	X	Land Registries Law Notaries Law
4.2. No (or minimised) notaries' fees	X	-	X	X	
4.3. No tax for asset transfer within Latvia	X	-	X	X	Corporate Income Tax Law Personal Income Tax Law
4.4. No extra income tax for the Cover Pool	X	-	X	X	
4.5. No extra tax on bank gaining profit from the Cover Pool	X	-	X	X	

Aspects creating issues under the current regulation	Locally relevant		Pan-Baltic relevant		Need to analysed at further law drafting stages whether amendments needed: carve-outs from and/or references to
	SPV	OBS	SPV	OBS	
4.6. No withholding tax on bond coupons (which exceeds the tax on other financial instruments)	X	X	X	X	
4.7. Not less favourable regime than than in other Baltic states	-	-	X	X	
4.8. No cross-border tax events	-	-	X	X	
5. Cross-border specific issues					
5.1. Cross-border recognition of claims (included in the Cover Pool) and enforceability of security in case of bank's insolvency	-	-	X	X	Civil Law, Civil Procedure Law
5.2. Supervisory authorities' conflict of interest	-	-	X	X	Credit Institutions Law Financial and Capital Market Commission Law
5.3. Equivalent and/or recognised property valuation methods	-	-	X	X	Land Registries Law

Creation of Pan-Baltic market and harmonising of legislation of all 3 Baltic States is addressed in more detail in a separate document Interim Report of Introduction of Pan-Baltic Covered Bond Legal and Regulatory Framework.

4.3 Features of ABS

In order to achieve a successful securitisation structure there are several legal 'building blocks', described below. The extent to which these are possible under current Latvian law or whether they may require legal amendments is discussed in section 5.

4.3.1 Special Purpose Vehicle

The entity which owns the assets and issues the bonds must be nominally independent of the bank in order to avoid consolidation for insolvency or resolution purposes and to avoid accounting or regulatory capital consolidation. Furthermore, the rating agencies will require the SPV to have independent controls to ensure that it acts in the best interests of bond holders.

Typically the Special purpose vehicle is either wholly or partly owned by an entity other than the bank. In many jurisdictions they will also have independent directors.

To ensure that the Special purpose vehicle will not enter into insolvency proceedings itself its activities will be restricted to the acquisition and funding of the assets (and absolutely necessary ancillary activities such as asset servicing and hedging). Furthermore bond investors will not have the right to petition a court to start insolvency proceedings in the event of a default on any notes.

The legal form of the SPV varies by jurisdiction, for example it may be a fund or a non-financial corporation. In some countries a new legal entity has been created for this purpose (for example, in France the law has established an entity known as 'fonds de commun des créances'). In other jurisdictions entities established under foreign law have been used.

4.3.2 Asset transfer

The assets must be transferred to the SPV. There are numerous ways in which this can be done in most jurisdictions.

The method used should:

- ensure that there is a clear legal claim over the assets which cannot, for example, be challenged by unsecured creditors of the bank. This will include ensuring that the transaction cannot be re-characterised by a court in the event of the bank subsequently entering resolution or insolvency;
- transfer both the primary assets (for example, the right to receive interest and payment under the mortgage agreement) and the ancillary rights (for example both the loan and the security over that loan);
- be compatible with the terms of the underlying assets. In some cases mortgage loan agreements have restrictions on the ability of the bank to transfer the assets;
- ideally, the method of transfer should prevent the borrowers included in the pool from netting their liabilities under the mortgage with any assets that they may have with the bank – such as their current account.

If the above criteria are all met the transfer could be described as a 'true sale'.

4.3.3 Creation of security

Ideally the creditors of the SPV should benefit from a security over its assets. The creditors are primarily the bondholders but will also include derivative counterparties and potentially for example, third party asset servicers. The relative ranking of these creditors, in particular of the different classes of bond holders will be determined by an inter-creditor deed.

In some jurisdictions the benefit of the security is held by a security Trustee for the benefit of secured creditors.

Security is not strictly necessary if the activities of the SPV can be sufficiently restricted to ensure that its actions will be identical to what would have occurred if such security had existed.

4.3.4 Credit Enhancement

In order to achieve the highest possible credit ratings, features will need to be included in the bonds to protect bondholders. The most frequently used form of Credit Enhancement is to transfer more assets to the SPV than the bonds which it issues (over-collateralisation). The difference is typically funded by the SPV via a subordinated loan from the bank.

Other forms of Credit Enhancement include:

- tiering of securities issued by the SPV. The SPV issues different series of notes some of which are subordinated to others and therefore provide protection from any credit losses on the assets in the pool.);
- spread retention. To the extent that the underlying assets yield more than the notes issued some or all of the interest difference may be retained in the SPV to protect against future credit losses on the assets, and
- swaps of the interest rate due on the assets for the interest rate due on the bonds. The SPV will typically enter into these swaps directly with the bank but the rating agencies will require that the swap terms include a requirement that the bank replaces itself as a swap counterparty in the event that it is no longer sufficiently credit-worthy, therefore in the event of the bank being downgraded they must find a better rated replacement swap counterparty.

Typically Credit Enhancement methods are defined in a transaction by contract, not statute. Therefore the above discussion on possible methods is included primarily for information only (although it will also be necessary to ensure that none of the possible Credit Enhancement methods contravene the law or banking supervisions)..

4.3.5 Creation of bonds

The bonds issued by the SPV will be subject to normal laws, regulations and supervision for bond issues by Latvian companies and/or financial institutions.

The securities will probably need to include inter-creditor agreements (to the extent that tranches of notes with different ranking security will be issued) and will require consent solicitation rules in order to ensure that amendments to programme documents can be made subject to bondholder consent. Latvian law sets the general principle of equal treatment of investors having securities granting similar proprietary and non-proprietary rights[12]; hence, contractual arrangement adhering to the said principle should be recognised by Latvian law. However, such ranking of securities might not be enforceable in case of Issuer's insolvency as ranking of the creditors in case of bankruptcy is established by law.

To the extent that the securities will be sold to non-Latvian investors cross-border withholding tax and settlement issues may also need to be addressed.

4.3.6 Tax neutrality

All aspects of the transactions should, wherever possible, ensure that no new taxation liabilities are incurred for the bond Issuer/Originator of the assets or the investor other than to the extent that they would for a normal bond issue.

This includes, inter alia,

- any tax including stamp duty on the transfer of assets to the SPV,
- tax of profits at the SPV other than to the extent that this tax would otherwise be incurred by the bank
- tax on the method by which profit is extracted from the SPV to the bank

[12] Although this principle is not formally stated in the Financial Instruments Market law, this is in line with the general principle that only fungible securities can be traded in regulated markets and in general it is in line with the aims and goals set in the Financial Instruments Market Law. The fact that this principle of equal treatment of investors is recognized in Latvia is also evidenced by the Article 41 of the Law on Alternative Investment Funds and their Managers that ensures that investors holding the same class of certificates of AIF receive the same rights .

- withholding tax on the bond coupons

A failure to achieve tax neutrality and the creation of any material new forms of tax would be likely to make the transaction uneconomic for Issuers and defeat the purpose of the legislation.

4.3.7 Other building blocks

Several other features are typically required to structure a securitisation but normally are governed by contract law rather than defined by statute.

For example: the bank will need to service the assets on behalf of the SPV, typically under a separate legal document. Rating agencies will require that it is possible to service these assets via a third party should that be necessary.

To the extent that the interest under the bonds is less than that on the underlying assets – that is, the SPV has positive net interest and, to the extent that the positive net interest is sufficient to cover any losses of principal as a result of defaults of the underlying loans - the difference will need to be transferred from the SPV to the bank.

4.4 Additional features of a covered bond law

In addition to the features which are in common with the securitisation law (section 4.1) and the determination of the broad legal structure (section 4.2), the covered bond law needs also to address certain differences and additional features. This includes the requirement that the covered bonds conform to European Union law (currently specifically Article 129 of the Capital Requirements Regulations) and the recommendations of the European Banking Authority.

In summary:

4.4.1 Definition of assets

The assets which may be used to back a covered bond are defined in article 129 of the Capital Requirements Regulations. However, most countries apply more stringent rules and all use more detailed asset definitions.

Key decisions that will be required include:

- whether to allow just residential mortgages or to also allow commercial mortgages and public sector receivables as are allowed under the Regulation;
- how to define the asset type (for example whether a ‘mixed-use’ property is primarily commercial or residential);
- whether to impose limits on certain types of exposure;
- how to value properties (for example according to a market value or a mortgage lending value);
- limits on the ratio of the loan outstanding to the appraised value of the property, and how to calculate this ratio;
- the eligibility of mortgages in arrears for the Cover Pool;
- definitions of and limits on ‘Substitute Assets’ – assets other than the primary asset class included in the Cover Pool, for example banks frequently hold short dated, highly rated securities or cash on deposit at the central bank in order to be able to meet imminent payment obligations under the bonds risk.

Wherever possible the rules governing the above points should be in line with both existing rules and market practice.

In addition to the primary assets the laws and regulations will also need to specify criteria with regard to Substitute Assets and derivative contracts.

Substitute Assets are typically high quality assets that can easily be converted into cash that are held, for example to meet imminent bond repayments. Criteria for these are specified under article 129 of the Capital Requirements Directive but may need to be augmented by national regulations.

Derivatives should be included in the pool only to the extent that they hedge mismatches between assets and liabilities. Furthermore they should be based on a modified version of normal ISDA documentation (for example to prohibit netting, or automatic termination on counterparty insolvency) and should rank *pari passu* with covered bond holders.

4.4.2 Obligations to buy back

The Issuer will have to repurchase and replace assets in the Cover Pool for reasons of credit (the mortgage has gone heavily into arrears), eligibility (a change occurs which generates a breach of the eligibility criteria), or other reasons.

The law will need to both oblige the Issuer to undertake this and ensure that the method of asset transfer to the SPV can accommodate it.

4.4.3 Investor protection

Many features will need to be included in the law and/or secondary regulations in order to protect the interests of covered bond holders. The primary source of protection against credit losses in the underlying assets is Over-collateralisation, that is including assets in the pool that exceed the total value of bonds and other liabilities of the pool.

Over-collateralisation can be calculated on the basis of the Net Present Value of the assets and the liabilities, nominal value, or both (or, in a small number of countries some other method such as 'prudent market value').

Typically:

- an absolute minimum level of Over-collateralisation is specified in the law, currently this is frequently either 3% or 5%.
- The supervisor is empowered to set a higher Over-collateralisation on a case by case basis. This is calculated with reference to the assets in the pool, the features of the covered bond programme and the credit-worthiness of the Issuer. It may be set after the use of 'stress tests' – a series of adverse assumptions about economic and credit conditions. These stress tests in turn may be specified in the law or regulations or may be set by the supervisor based on current conditions.
- Issuers contractually commit to maintain a higher level of Over-collateralisation in order to ensure the highest possible credit rating.

In addition to Over-collateralisation, rules will need to be put in place to ensure that the pool has sufficient liquidity to meet obligations as they fall due. This is analogous to the Liquidity Cover Ratio rules for banks. There are however multiple ways to calculate it based on, inter alia, the nature of the underlying assets.

4.4.4 Implications of the segregation of bond Issuer and asset owner

As the Issuer of the bonds and the holder of the assets are separate legal entities prior to insolvency the law, secondary regulations and contractual terms will need to accommodate the below insolvency structure.

The bonds are full recourse obligations of the Issuer and benefit from a guarantee from the SPV. The Issuer pays a fee to the SPV which is an appropriate economic value for the guarantee provided (i.e. fee determined on "arm's length" basis).

In an event of a default under the Issuer's obligations under the bonds – for example to make a coupon payment - the guarantee is activated and the SPV is obliged to make payments under the bonds according to the original schedule of interest and principal. At this time the SPV claims under an indemnity against the insolvency estate of the Issuer an amount equal to the principal and future interest payments. That is the claim under the indemnity is accelerated whilst the payments under the bond are not.

If the Cover Pool itself subsequently becomes insolvent – because credit losses on the underlying assets recue the Over-collateralisation to zero then the payments under all of the bonds become immediately due and payable.

4.4.5 Treatment of Cover Pool in insolvency

Post Issuer insolvency the SPV should be empowered by the law to enter into contracts as and when required to ensure the continued service of the underlying bonds. These contracts will include, for example the ability to enter into funding secured on the assets (either in the form of covered bonds, securitisations or asset sale or repo) and the ability to enter into derivative and asset servicing contracts.

The non-bank nature of the SPV may influence its ability to enter into these contracts, for example to repo the underlying assets with the central bank. This should be taken into account in the legal drafting process.

The law may need to establish a new legal entity (traditionally a 'Special Administrator') to manage the SPV post insolvency.

If bankruptcy proceedings are initiated against the Issuer, the proceedings are limited to the general estate of the Issuer, and that the special estate and the debts and obligations it covers do not form part of the bankrupt estate of the Issuer.

Moreover, the proceedings do not cause the obligations and debts of the special estate to become due and payable.

4.4.6 Supervisory regime

The day to day supervision of covered bond programmes should be undertaken jointly by the supervisor and an independent agent appointed by the Issuer (typically referred to as a Cover Pool Monitor). The criteria for the Cover Pool Monitor and the division of monitoring and supervising responsibilities will need to be specified.

The supervisor will need to specify the nature of the supervisory regime in three main sections:

(i) approval to issue, licensing. This will include for example whether licensing is on a programme-by-programme or bond-by-bond basis and what information should be supplied to the supervisor;
(ii) on-going supervision. This will include for example the extent of the supervisors on-going responsibilities and powers;
(iii) post-insolvency powers and responsibilities.

The above features will be included in both the primary law and secondary legislation. For reasons of efficiency the details of these features should be included in secondary legislation wherever possible

and primary legislation used mainly to allow this to happen (for example, granting the supervisor the right to set regulations).

5 Application of the features of ABS and covered bonds in Latvia

Although covered bonds and securitisations differ in certain significant ways there are substantial legal synergies which suggest that the two instruments should be legislated in the same act of parliament, whilst recognising the need for a clear distinction between them.

Thus, the legal building blocks, which are necessary for securitization and covered bonds programmes, in principle correspond, unless expressly indicated otherwise.

The relevant building blocks are described below and are as follows:

(i) Establishment of an SPV;
(ii) Asset transfer;
(iii) Amendments to bank insolvency and resolution processes;
(iv) Rules regarding the issuance of securities;
(v) Rules establishing tax neutrality.

5.1 Current status

Currently there is no appropriate and up-to date legal framework for covered bonds and securitisation in Latvia.

Latvian securitisations could be made mainly by applying the general provisions of the Civil Law regulating the transfer of claim rights and creation of security, alongside (if relevant) respective corporate laws and laws normally regulating securities markets. To our knowledge, so far there have been no securitisations with an SPV established in Latvia.

Latvian law facilitates the issuing of mortgage bonds, however, in practise this instrument is rarely used - until this date only one bank has in practice attempted to test the issue of mortgaged bonds in Latvia, and no bonds remain outstanding at the moment. The Law on Mortgage Bonds, which had the latest amendments in 2006, is also outdated.

Therefore we recommend a creation of a legal framework to provide for both covered bonds and securitisation. We suggest that it is done via: (1) adoption of a new law, which specifically governs covered bonds and securitizations (hereinafter referred to as the “New Covered Bond and Securitization Law”) and (2) amendments to the existing legislation.

5.2 Incorporation of Special purpose vehicle (SPV)

The securitisation and covered bonds law should ensure the following:

- simple procedure for an SPV to qualify as a securitisation/covered bonds vehicle (e.g. a statement in articles of association on the activity suffices);
- restriction of activities of SPV by law, to acquisition of (or assuming the risks related to) the assets, claims and obligations assumed by third parties or inherent in third parties activities (and for securitizations – also issuing securities); hence, prohibiting any activity that may qualify as entrepreneurship, including creation of additional indebtedness in SPVs;
- no additional minimum capital requirements;
- simple and low-cost liquidation procedure upon SPV achieving its objectives;
- as simple as possible management structure;
- governance that is independent from the bank;
- SPV must not qualify as a financial institution;

- no authorisation, licencing, permits for SPV (e.g. no consumer credit licence requirement if consumer loans are securitised).

Accordingly, amendments may be needed to certain laws, including – the Data Protection Law, the Consumer Rights Protection Law (please refer to section 5.7).

5.2.1 Preferable legal form of the SPV

An SPV, which is used for either covered bonds or securitizations, in Latvia could be established in the form of private limited liability company (in Latvian – *sabiedrība ar ierobežotu atbildību*, abbreviation - *SIA*), owned by the bank or a company belonging to the same group as the bank.

Other potential types of forms, such as limited partnership or a fund in the form of aggregation of property (hereinafter referred to as the "fund") would not be as compatible with the characteristics needed for the securitizations and covered bonds.

A key benefit for limited liability companies is that they allow creating a true severability of liability of the legal entity and its owners. A legal entity is liable in the amount of its owned assets.

Further, establishing the SPV in the form of a partnership or a fund might not achieve sufficient independence from the bank, as for these types of entities entail significantly more involvement of the owner – for example with the people responsible for the day to day running of the SPV being typically being employees of the issuing bank. Furthermore it is frequently easier to define the permitted activities of the entity in a company's articles of association . Since the SPV should act primarily in the interests of the investors – bondholders, whereas the bank must act in the interests of all of its clients, the interests of these two entities might conflict. Thus, the management of the SPV should be independent, which could be achieved in the public or private limited liability company scenario.

Finally, establishing the SPV in the form of a fund would not be advisable, as in this case ensuring the asset separation in the bank's insolvency would be challenging under the current regulation (for more considerations on the insolvency issue refer to Section 3.1-3.2).

5.2.2 Restricting of SPV's activities

SPVs' actions should be clearly restricted to actions needed for securitizations or covered bonds programmes in order to avoid insolvency and other risks. The restrictions should prohibit any activity that may qualify as entrepreneurship, including creation of additional indebtedness in SPV. Such restrictions should be established by law. Although possibility of restricting the activities may be achieved through respective limitations in the SPV's articles of association, under Latvian law this might not ensure sufficient protection. This is because regardless of any limitations on the representation established in the articles of association of the SPV, the latter, being a private legal entity, generally may pursue any activity and acquire any civil rights and obligations. If the SPV concludes a transaction contrary to the limitations in its articles of association, then the mere disclosure of the restrictions in articles of association after such transaction is not sufficient ground to challenge the transaction. The proof that the counterparty deliberately acted in bad faith (e.g. knew about existence of such limitations) is needed. This can be solved if the activities of the SPV are restricted by law in general, e.g. – by limitations in the New Covered Bond and Securitization Law.

5.2.3 No additional regulatory requirements and no complex licencing procedure

As the covered bonds and securitizations involve the legal transfer of rights related to residential mortgages, then after the transfer, under the current regulation the SPVs might fall within the scope

of licenced activities (consumer lending, debt recovery, etc.) This could be solved in one of the following approaches.

First, any licencing requirement for the SPV could be avoided, if it is ensured that the activities subject to licencing remain with the bank at all times.

Secondly, special licences could be introduced for SPVs, if such licences are needed for the performance of any actions related to the transferred assets. However, this approach would not be the best solution for securitization, since in general issuing of securitizations should be possible for any types of entities. Whereas in the case of covered bonds, which are more strictly regulated, a one-off licencing might be feasible, provided that the licencing has as simple as possible procedure and reasonable costs. The licencing procedure should be introduced in the New Covered Bond and Securitization Law.

Finally, the actions subject to licence could be outsourced by the SPV to a licenced entity. The latter approach has been used in practice in Latvia, e.g., when commercial loans are transferred to a non-licenced entity. In this case the actions requiring licence, namely, debt collection are outsourced to an entity, which is licenced for the debt recovery services. In this case the law should oblige the bank to only transfer the assets to a Servicer which has sufficient licenses in place. This approach might necessitate amendments in the Consumer Rights Protection Law and the Law On Extrajudicial Recovery of Debt (see section 5.7).

5.3 Asset transfer

Pursuant to Latvian law the title to assets may be transferred by virtue of the assignment of a claim alongside either of the following institutes (depending on the case): (i) sale - purchase[13] or (ii) donation (dāvinājums)[14], or (iii) factoring[15]. Further we elaborate on particular aspects of assignment of a claim and sale-purchase, which is the most significant option in practice, considering that other alternatives are not preferable from either the current tax or insolvency regulation perspective, i.e., they can be easier challenged in case of bank's insolvency. From tax perspective donation of claims to a related party would be considered subject to corporate income tax for the donating party, while in factoring transactions generally value added tax applies on the factoring commissions. [16]

The asset transfer from the bank to the SPV might be performed in two stages: (1) assignment of assets by sale-purchase and (2) if necessary - universal asset transfer in the case of bank's insolvency.

The law regulating securitisations and covered bonds should regulate such transfer by ensuring:

- actual transfer of title ("true sale") to assets instead of mere creating security securing the assets;
- effective segregation of the assets of the SPV and the bank;
- avoidance of consents and individual notifications to the debtors;
- simple and low cost transfer of security.

The regulation on securitizations specifically should allow broad list of assets eligible for securitisations (loans, mortgages, non-performing loans, lease receivables, trade receivables,

[13] Civil Law, Article 2002 (in more details: 2002-2072); Commercial Law, Articles 407-414
[14] Civil Law, Articles 1912-1924
[15] Commercial Law, Articles 468-473
[16] The exemption from VAT provided in Article 135 (1) (d) of the Council Directive 2006/112/EC (VAT Directive) does not apply to factoring transactions according to the Judgement of the European Court of Justice in MKG case C-305/01.

receivables of the financial institutions, as well as tangible (e.g. equipment) and intangible asset classes (e.g. intellectual property), both existing and future ones).

5.3.1 Assignment of claims – transfer of assets on a regular basis

By virtue of assignment a creditor transfers the claim rights he has against a debtor to another creditor. In case of assigning rights deriving from an agreement, which is in practice the case of securitizations and covered bonds, the agreement itself is not transferred, but only the creditor's claim rights relating to the agreement are.[17] Various claim rights may be assigned – contractual as well as other claim rights, existing or future claims.[18] Together with the claim all ancillary rights are also transferred, including the security backing the claim, unless the creditors concluding the assignment have agreed otherwise. Generally no consent of the debtor is needed for the assignment.

Restrictions to assign

There are specific statutory and potential contractual limitations for the assignment, which in order to endorse covered bonds and securitisations, have to be removed or at least eased:

- the assignment must comply with the regulatory requirements (please refer to section 5.2.3 above),
- the assignment must not detriment the debtor's statutory rights (e.g. consumer rights, personal data protection rights, bank secrecy) - (ref. to the next sub-section – "Statutory restrictions for assignment")
- the assignment must not detriment the debtor's situation under the contract (ref. to second next subsection) (e.g. rights to receive information on the changes relating to the creditor, right to consent to such change, rights provided in the Mortgage Credit Directive).

Statutory restrictions for assignment

Debtors, whose agreements might be transferred for securitizations or covered bonds purposes, might be subject to several statutory rights, such as the right to bank secrecy, personal data protection, consumer rights, etc. It might be argued that the transfer affects their rights, hence, their consent for the transfer or at least for the sharing of their personal data is needed. This would lead to a significant administrative burden for the banks transferring the assets to the SPV, thus the issue should be addressed at a statutory level. For example, for addressing bank secrecy issue, a carve-out in the Credit Institutions Law could be introduced, i.e. that such data transfer without express client's consent would be allowed under bank secrecy regulation. As for the personal data protection issue, the transfer of assets for covered bonds or securitizations purposes should be stated as one of statutory grounds for processing personal data (insofar as any personal data processing even takes place), whereby the express consent is not needed. Thus, amendments might be needed in several laws, including the Credit Institutions Law, the Consumer Rights Protection Law, the Data Protection Law (see section 5.7).

[17] Civil Law, Article 1800
[18] Civil Law, Article 1798

Contractual restrictions for assignment

In general, the assignment may not prejudice the debtor's rights under the contract. For example, if the debtor is entitled to the right of set-off, this right shall be preserved. Exemptions apply only in the case of bank's insolvency or restructuring. For enabling the securitisations and covered bonds, a carve-out from this rule, applicable not only upon insolvency of the bank, might need to be introduced:

- the debtor may set-off its claims against the initial creditor that were due at the moment of the notification[19];
- the debtor shall have the right to raise against the assignee (the new creditor) all the defences which it was entitled to raise against the assignor at the time of receiving the notification on assignment of a claim.[20]

Further consideration from stakeholders of the implications on these and other contractual restrictions for the asset transfer is requested. Also, the ability of bank's IT systems to report and quantity any such restrictions and their interaction with deposit insurance should be considered.

Notification

> Given that securitisations are usually made without notifying the debtors (unless in exceptional cases, e.g. insolvency of Originator), the securitisation framework should establish a possibility of public notification of the assignment.
>
> This would allow the assignee to claim that he has a valid and enforceable title, where practical aspects on how further to instruct the debtors, if at all, should be left to the discretion of the parties.

Failure to notify the debtor on assignment of a claim does not render the transaction null and void (subject to limitations of the contract), however, in the absence of notification the debtor may perform its obligations to the initial creditor or to the one of successive creditors (if a claim is assigned several times and some assignments are notified), and such fulfilment is deemed valid, which the assignee may not challenge. Please also see section 5.7 regarding possibilities to postpone the notification until it is needed in practice, e.g., in case of bank's insolvency.

Sale-purchase

The specific method of moving the assets into the SPV is the conclusion of a sale-purchase agreement between the Issuer (bank) and the SPV. Under Latvian law the sale-purchase of claim rights is possible just like the more traditional sale-purchase of tangibles (goods).[21] However, the law should be more specific and recognise the peculiarities of the sale-purchase of claims for the securitisation and covered bonds purposes, e.g., provide the concept of the "true sale" of assets.

Result of transfer – a complete segregation of assets of the bank and SPV

The assets of the bank and the SPV must, after the assignment, be completely segregated, in order to ensure that in no cases the SPV may be held responsible for the activities of the bank. This is significant not only in the insolvency scenario (addressed further in Section 5.4), but also in any legal proceedings.

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[19] Civil Law, Article 1808
[20] Civil Law, Article 1808
[21] Civil Law, Article 2002, Article 2005

For example, the court may on its own initiative or upon request of the creditor apply certain interim measures on the assets of the bank. The asset transfer should achieve a situation where no interim measures upon the bank (including restrictions on disposals) may be applicable with regard to cover assets transferred to and powers vested in the SPV.

5.3.2 Business transfer as a going concern – in the case of insolvency

Under Latvian law assets of a company may also be transferred by way of the transfer of the business under the so called transfer of enterprise (in Latvian – *uzņēmuma pāreja*).[22] As well as there is a special regime for transfer of bank's undertaking that gives much more freedom to the parties in defining the scope of relevant transferred enterprise.[23]

For covered bonds, this type of asset transfer could be implemented in the case of insolvency of the bank, in order to facilitate the complete transfer the contractual relationships relating to the loans (as noted in the above Section 5.3.1, the assignment only results in the transfer of claim rights).

In the case of business transfer of a bank (transfer of bank's undertaking), the whole business, or, if needed, also a part of business can be transferred to another person (not necessarily a bank).[24] The business transfer of a bank can be either an aggregation of assets or liabilities or the aggregation of standard contracts entered into with the bank's clients or a part thereof, or a branch of a bank. In practice, this means that part of the loan portfolio can be transferred to the SPV while the other part remains with the bank originating these loans.

The following aspects make business transfer attractive. Business transfer is a universal transfer of all rights and obligations (including ancillary rights and the security, subject to perfection requirements – refer to Section 5.4.4) business transfer of the bank enables not only transfer of business portfolio as a whole, but also transfer of any part of the bank's business, which can be clearly distinguished (e.g. a portfolio of specific loans).[25] No consents of counterparties or creditors are required for the implementation of business transfer. Also, there is greater resistance to possible challenges of the transfer and the integrity of transferred assets, ensuring continuity of agreements (including security) on the same terms so as if there had not been any transfer. After the transfer has been effected, in respect of contracts for provision of financial services the transferor and the transferee are not jointly liable in case of bank's business transfers (as opposed to transfer of business of non-regulated entities).[26]

The main administrative burden associated with bank's business transfer is that the approval of the regulator, the Financial and Capital Market Commission, is needed. However, if the business transfer is only performed once, in the case of bank's insolvency, this would not be a significant obstacle, as the administrative burden due to obtaining of the permission would outweigh the benefit that bond holders receive.

Also, under the current regulation the decision on business transfer in case of insolvency is taken by the insolvency administrator. Thus, in order to facilitate covered bonds usage, this rule would need an exemption - i.e., the decision regarding the assets forming of Cover Pool is within the Cover Pool's administrator's discretion. This is needed, because the Cover Pool's administrator's main goal is to protect interest of bond holders while the bank's insolvency administrator will not see that protection

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[22] Commercial Law, Article 20
[23] Credit Institutions Law, Article 59.2
[24] Credit Institutions Law, Article 59.^{2}
[25] Credit Institutions Law, Article 59.2
[26] Credit Institutions Law, Article 59.2

of these creditors is his primary task (for more aspects on insolvency please refer to section 5.4). Therefore, amendments to the Credit Institutions Law might be required (see section 5.7).

5.3.3 Creation and transferability of security

Creation

For securitizations, in order to ensure the investors' priority rights over the pool of assets, the assets of SPV have to be either provided as security in favour of investors (SPV model) or ring-fenced from claims of other creditors by provisions of law (OBS model).

Accordingly, necessity to amend currently valid legislation should be further discussed (please also see section 5.7).

Investors' priority rights in Latvia might be created using the following instruments: (i) commercial pledge (registered pledge); (ii) mortgage; (iii) suretyship. Mortgages may be used for securing the covered bonds, whereas securitizations could be secured by any of these types of security. Security in favour of investors need to be duly contractually created, perfected (registered if needed) in order to create investor's priority rights over the pool of assets.

Transfer

For both the covered bonds and securitizations, the security securing the transferred claims must be transferred from the bank to the SPV along with the assets. Simple, efficient and non-costly transfer of security is one of the core factors for successful covered bonds and securitisations market in Latvia.

Under current regulation the transfer of security may be complicated and onerous (multiple and costly piece-by-piece re-registrations), therefore, certain amendments (or specific provision in the New Law on the Covered Bonds and Securitization) might be needed, which would enable one-off action for re-registration of pool (or bulks) of assigned registered security or at least simplify the currently effective process for transfer of mortgages.

As a general rule under Latvian law all ancillary rights (i.e., also security) is transferred to the new creditor together with the claim, and no consent of the debtor is needed.[27]

However, there may be additional requirements for transfer of security, such as:

- transfer of certain security registered with the public registers may need to be recorded in the respective registers;
- security agreement and/or the secured agreement may limit and/or restrict the transfer of rights and obligations.

Registered pledge and mortgage

Registered pledges and mortgages come into effect against its parties from the moment of the signing of a respective security agreement (unless the agreement itself sets forth otherwise). However, registered pledges and mortgages can be used against third parties and can be enforced only when they have been registered with the public registries - the Commercial Register (for registered pledges) or the respective Land Register (for mortgages). Registering of mortgage entails filing of an application

[27] Civil Law, Article 1806; also Civil Law, Article 1375 in respect to mortgages and Commercial Pledge Law, Article 35 in respect to registered pledges.

to the Land Register, in case of registered pledges application is filed to the Commercial Pledge Register.

The amendments in the entries of the Land Register are not automatic and currently there is no possibility to re-register the pool of registered security interests based on one asset transfer agreement, i.e.: the re-registration must be done under piece-by-piece basis. Sometimes in case of bank business transfer parties have managed to agree on possibility to list several mortgages in one application, however, that only diminishes the issue, but does not fix it. Thus the registration entails significant costs and administrative burden in the case of registering multiple mortgages at once, which is necessary for establishing of the Cover Pool and also for adding or removing bulks of assets to the pool as necessary. The same applies to the registration of transfer of registered pledges. Hence, amendments might be needed to Latvian laws (e.g. the Land Registries Law and the Commercial Pledge Law) or specific provisions need to be included in the New Law on the Covered Bonds and Securitization (see section 5.7).

Alternative – subsequent registration when needed

Based on experience of other jurisdictions we suggest to discuss and consider the further described solution that can equally apply to the OBS model and SPV model. Each month the bank (Issuer) will produce a list of the assets included in the asset pool, this will differ month to month as assets in the asset pool mature, prepay, default or change their terms and are replaced by other assets. This list will include both 'primary assets' – mortgage loans – and other assets such as cash and securities held to satisfy liquidity needs of the asset pool. The full list will be lodged with the Cover Pool Monitor and the FSA in order for them to fulfil any necessary review of the adequacy of the asset pool.

In addition, the list of primary assets will be submitted each month with the Land Register and other public registers, if applicable. The Land Register or any other public register, if applicable, will not enter into amendments regarding the inclusion of the relevant mortgage, pledge in the asset pool until such time as this is necessary, for example, the insolvency or resolution of the bank (Issuer). In that case, each entry on the list previously submitted to the FSA and the Land Register or any other public register, if applicable, will be transferred to the appropriate property, i.e., the entries will be made to ensure that the security interest is established for the benefit of the Cover Pool. The technical implementation process and costs are still being discussed amongst stakeholders (please also see section 5.7). The cost of such exercise shall be estimated by the bank (Issuer) at the issuing of covered bonds and an amount of cash sufficient to undertake such security interest transfer shall be held in a reserve account (which will not be accessible to the creditors of insolvent bank or creditors of bank subject to resolution).

Suretyship

The suretyship is an accessory obligation (dependent upon the obligation of the principal debtor for which it has been entered into) where the surety is liable with the principal on joint or several liability basis. There are no special rules for transferability of claims secured by the surety, thus as a general rule, the security should follow the transferred claim/obligation.

Security Trustee

For the purpose of covered bond and securitisation frameworks, specific adjustments introducing a clear concept of security Trustee able to hold security in its own name are needed. This would enable to more efficiently exercise the creditors' rights and administer the pool of assets.

Generally neither the concept of the security agent nor other legal concepts in Latvian law cover usage or specifics of a trust (as it is understood in common law) as the holder of security on behalf of other beneficiaries.

5.4 Impact of the bank's insolvency or recovery on the pool of assets

In order to enable the on-going servicing of the pledged assets and further continuance of both the securitisation and covered bond program, the following must be ensured in the bank's insolvency:

- dual recourse for the bond holder to claim from both the assets of the Issuer of the bonds (or their insolvency estate) and from the assets in the Cover Pool (covered bond only);
- all receivables comprising covered assets have to be fully legally segregated from the bank's insolvency estate, and hence, any possibility to comingle receivables for settlement with bank's creditors must be avoided; no re-direction, transfer of receivables into a single account where all funds from the commercial activity of the insolvent bank are accumulated (both instruments);
- a priority claim for the investors on the principal and any accrued interest from assets included in the Cover Pool in respect to the other creditors of the bank (both instruments);
- no requirement to make any arrangements of the creditors in respect of the Cover Pool (both instruments);
- no acceleration of debtors' obligations, receivables wherefrom comprise the Cover Pool (both instruments);
- restrictions to further fulfilment of outstanding and not fully performed bank's obligations (including calculation and payment of interests, default interest etc., (both instruments);
- no review and challenging by the bankruptcy administrator of covered bonds or securitisation documents and as to further continuance of agreements relating thereto (both instruments);
- no limitation, suspension of mandate of the special Cover Pool administrator (covered bond only);
- collection of receivables by the special Cover Pool administrator (covered bonds) or substitute Servicer (securitisations) and their transfer to investors when needed may not be suspended or otherwise negatively affected either;
- continuous management of the covered bond programme during the period of the insolvency process (no limitations of the bank's (commercial) activity related to servicing of the covered pool; if necessary – transferring the SPV to another banking group);
- no stay on enforcement on the Cover Pool assets, i.e., that the Cover Pool assets cannot be used to settle claims of bank's unsecured creditors, but is available only to covered / securitisation bond holders;
- no insolvency related fees may be deducted from the pool of cover assets: investors do not finance insolvency/bankruptcy/restructuring/liquidation of the bank (both instruments).

5.4.1 Challenges, which are solved by using the SPV structure

The following rules of Latvian bank insolvency regulation under the Credit Institutions Law, which create potential challenges for covered bond and securitizations transactions, would be solved by transferring the Cover Pool to the SPV and thus ensuring the separation of the Cover Pool from the insolvency estate:

- insolvency administrator is appointed, and as of appointment, he is the sole person entitled to (i) act with the bank's property and also with the property of other persons, which the bank has within its possession or keeps for such persons, and (ii) to manage the bank's activities;[28]
- delay payments and interest of creditors' claims stop accruing.[29]
- the judgment in which the court declares the credit institution insolvent constitutes the basis for a stay of civil proceedings initiated against the credit institution and for a termination of judgement enforcement proceedings in cases regarding the recovery of amounts adjudged against, but not yet recovered from the credit institution[30].

5.4.2 Challenges to be resolved

The following issues remain outstanding under the current legislation, even if the SPV structure is introduced and used. Thus, carve-outs from these rules should be introduced in respect to securitizations and covered bonds that limit the rights of insolvency administrators to:

- void transactions, which the bank has entered into, within five years of the insolvency, whereby, losses are incurred for creditors;
- withdraw unilaterally from performance of the contract if the performance thereof reduces assets of the bank and the contract does not regulate the provision of financial service;
- submit to the court any claim of the bank against a third person,[31]
  (thus, administrator could challenge the bank transferring the contracts to the SPV);

The proposed special treatment of certain types of asset classes in bank's insolvency is not an uncommon concept under Latvian legislation, which provides, e.g. the separation of mortgage bonds and private pensions funds' assets from the general estate of the bank.[32]

Banks' restructuring proceedings (in accordance with the Law on the Recovery and Resolution of Credit Institutions and Investment Broker Firms) also pose similar issues as above.

Taking into account the above, amendments might be needed to the Credit Institutions Law and the Law on the Recovery and Resolution of Credit Institutions and Investment Broker Firms (see section 5.7).

5.5 Bond issuance

Distribution of bonds issued within securitization and covered bonds programmes would be governed by the Financial Instruments Market Law.

According to this law, the distribution by way of public offering may trigger prospectus requirement.[33]

Public offer means a communication to persons in any form and by any means offering securities and presenting sufficient information on the terms of the offer and the securities to be offered so as to enable an investor to decide to purchase or subscribe to these securities. Offering of securities through intermediaries of public trading in securities shall also be deemed public offering provided it meets the features of the public offering. Communication to persons via the regulated market of the Republic of Latvia is not deemed to be a public offering of securities. For the public offer of securities the Issuer

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[28] Credit Institutions Law, Article 149(1)-(2); 171; also Article 161
[29] Credit Institutions Law, Article 149(3)
[30] Criminal Procedure Law, Article 367
[31] Credit Institutions Law, Article 161(4)(3)-(4)
[32] Credit Institutions Law, Article 191
[33] Financial Instruments Market Law, Articles 14 – 24.1

must prepare and publish a prospectus (offering documents with detailed requirements), unless the offer falls under exemptions which discharge the Issuer from said obligations.

5.6 Tax neutrality

5.6.1 Transfer of the assets to the SPV

In most cases it will be possible to achieve the transfer of claims without immediate tax effect for the Originator if the SPV is established in any of the Baltic states (or, in case of Estonia, the bank) and the transaction's value is arm's length.

Taxation of losses from transfer of claims

Since Latvia has a deferred corporate income tax (hereinafter referred to as the "CIT") system, the Originator will not face any immediate CIT consequences from capital gains realised from sale of assets, but rather CIT will be payable upon profit distribution (or deemed profit distribution).

If the Originator transfers claims to the SPV and Originator incurs losses from such transaction, the losses should be included into the taxable base, except if the purchaser of claims is CIT (or comparable) taxpayer and resident in EU/EEA country or a country with which Latvia has concluded a double tax treaty, and either:

- the transaction takes place between unrelated parties, or
- the transaction value is arm's length.

The mentioned exception will be in force, if the Originator transfers assets to SPVs established in either of the mentioned countries, including Lithuania and Estonia.

In the normal course of events in both securitisations and covered bonds the assets are transferred to the SPV at their fair value which should equate to the value that they are currently held at by the bank. Therefore there is not normally a profit or loss on sale. However, in case of securitisations potentially non-performing loans may be transferred to SPVs, meaning that Originator shall realise losses from transfer of claims.

Transfer pricing regulations

Since the SPV will be established as a separate corporate entity (private or public limited liability company), it will be CIT payer. All transactions with related parties must be arm's length, otherwise any adjustments to the arm's length remuneration shall be included into the taxable base. There are certain requirements towards the taxpayers to prepare the transfer pricing documentation. The administrative burden of preparing transfer pricing documentation might be reduced if SPVs are not considered CIT payers.

Value added tax

Supplies of goods and services are in general subject to value added tax (hereinafter referred to as the "VAT") unless specific exemptions and exceptions apply (provided that the place of supply is Latvia). All transfers of claim rights are treated as being outside of the scope of VAT.[34] Nevertheless, if such claims are transferred by way of entering into a factoring agreement with SPV, any SPV (factor's) remuneration is generally subject to VAT at a standard rate of 21%, as the financial services exemption

[34] According to the Judgement of the European Court of Justice in GFKL case C-93/10.

does not apply to factoring transactions (both true and quasi factoring according to the Judgement of the European Court of Justice in MKG case C-305/01). However, considering the aim of the covered bonds and securitisations, the VAT treatment of factor's remuneration should be specifically approved with Latvian Ministry of Finance. A business transfer is not subject to VAT under Article 7(2) of the VAT law.

5.6.2 Taxation of the SPV

In order to ensure that no excessive CIT is incurred due to the structure of the covered bonds and securitisation instruments, we suggest amending the CIT law to state that SPVs are not considered CIT payers in Latvia.

Still if SPVs are considered CIT taxpayers, the exemption from thin capitalisation requirement SPVs should be introduced with respect to the SPVs.

Latvia's double tax treaty network should be extended and existing treaty benefits improved to minimise foreign tax exposure on SPV's foreign sourced income.

Corporate income tax

As mentioned, an SPV established in Latvia is fully liable to CIT. In Latvian corporate income tax system company's profits are taxed only upon their distribution or in case of certain deemed profit distributions. The deemed profit distributions are considered:

- Deemed dividends (increase of share capital from profits realised as from 1 January 2018 and followed by share capital reduction);
- Non-business expenses;
- Certain bad debts written off (upon writing off bad debts, the respective amount shall be included into the SPV's taxable base);
- Interest expenses exceeding the thin capitalisation limitations;
- Certain loans to related parties;
- Transfer pricing adjustments;
- Benefits to the employees and board members, if such are attributed to the permanent establishment of the company in Latvia;
- Liquidation quota.

In covered bonds scenario, according to the transfer pricing regulations, since SPV acts as a guarantor for the Originator's issued covered bonds, the SPV must receive arm's length remuneration for the guarantee service. In most cases the arm's length remuneration for the guarantee is equal to the cost benefit that the Issuer derives from issuing a covered bond rather than an unsecured bond with the same maturity on the same date. This can be certified by, for example, the investment bank arranging the transaction and should be taken into consideration when preparing transfer pricing analysis for tax purposes.

In case of securitisations, the SPV might realise profits, e.g. if the assets purchase price initially is lower than the SPV's actual profitability when claims are paid back. Upon payment of dividends from SPV to the Originator, CIT shall be payable. To compare, had the Originator issued the bonds by itself, CIT obligation would be deferred until profit distribution to the Originator's shareholders, if such profit distribution is made at all.

As long as the Originator and SPV are two separate CIT payers, it is likely that CIT liabilities in total might be higher compared to the situation when the Originator issues, e.g. regular bonds on its own. The additional CIT liabilities may arise when profits are distributed by SPV to the Originator. In order to mitigate the potential additional CIT liabilities, the transactions should be structured to minimise

profit distributions to the Originator. Alternatively, the additional CIT liabilities may be avoided if the SPVs are included into the list of entities, which are not CIT payers in Latvia. In such case, any profits would be extracted from the SPV to the Originator without CIT and taxed only when Originator distributes dividends to its shareholders.

In Latvia, according to thin capitalisation rules, the debt-to-equity ratio should be 1:4. Exceeding interest expenses should be included into taxable base. Also, if interest expenses exceed EUR 3 million annually, only interest expenses up to the 30% of EBIT limit are allowed, and the excess is subject to CIT. Therefore it is important that the capital structure of the SPV is planned before the transactions, otherwise SPV might face CIT liability. With respect to thin capitalisation rules, an exception may be introduced in the tax law to exempt the SPVs from such limitations in case if SPVs remain as CIT taxable persons.

The standard CIT rate is 20% which applies on the taxable base multiplied by coefficient 0.8.

Value added tax

The creation and issuance of securities is not subject to VAT. Transactions in securities (including bonds), dealings in credit guarantees or any other security for money are exempt from VAT.

As an SPV engages in wholly or mainly non-taxable or exempt activities, an SPV would have a limited right to deduct any input VAT incurred on the acquisition of goods and services subject to VAT (e.g. servicing).

5.6.3 Profit extraction from the SPV

Dividend payments are included into CIT taxable base of the SPV, therefore it is more beneficial to structure transactions in a way that minimises dividend payments. Although in certain cases the overall tax burden may be reduced by structuring the transactions in a certain way, the tax neutrality can be fully achieved if SPVs are not considered CIT taxpayers in Latvia.

Exemption of servicing from VAT is necessary and should be ensured in so far that the European VAT Directive framework allows an exemption. Legal certainty on the scope of different VAT exemptions with respect to ABS and covered bonds is necessary.

Loans provided by Originator to the SPV

Any interest paid by an SPV to an Originator would constitute a deductible expense for an SPV and taxable income for an Originator with taxable presence in Latvia. Any interest paid to Originators established within the European Economic Area or a country with which Latvia has an effective double tax treaty would be exempt from withholding tax in Latvia. Interest payments to black listed jurisdictions are subject to 20% withholding tax.

Thin capitalisation restrictions should be respected where an Originator is the SPV’s controlling entity. Failure to meet thin capitalisation limits would result in interest attributed to the debt in excess of the ratio being non-deductible for an SPV. For the thin capitalisation rule not to impede tax efficient financing of an SPV, legal acts could exempt securitisation vehicles from thin capitalisation restriction.[35]

[35] Under the current rules, thin capitalisation restriction already does not apply to credit institutions

Furthermore, transfer pricing requirements would apply where an Originator and an SPV are associated entities (potential risk of interest non-deductibility for an SPV).

The granting and negotiation of credit and transactions in securities are in general exempt from VAT.[36]

Deferred purchase price payments for assets

There are no legal rules under which the deferred price should be treated as interest for tax purposes and would thus be subject to withholding tax at source. However, the deferred payment of purchase price will most likely be considered as being a loan issued by Originator to the SPV and thus subject to calculating interest, when the Originator and SPV are related parties and both of them are CIT taxpayers.

Service fees paid by SPV to Originator

Service fees would be deductible for an SPV and attributed to taxable income of an Originator with taxable presence in Latvia. Transfer pricing requirements would apply where an SPV and a Servicer are associated entities.

There is no specific VAT exemption for servicing with respect to ABS and covered bonds. Depending on the asset type, servicing could either be exempt from VAT, or subject to VAT at a standard rate of 21% (provided that the place of supply is Latvia). For example, a credit management exemption could potentially apply with respect to credit receivables.[37] This may only apply to servicing performed by an Originator who granted the credit, but not a third party. Additional legal certainty is necessary with respect to the application of this and other VAT exemptions with respect to ABS and covered bonds, i.e., laws should state that no VAT on servicing is applied to the extent this is in line with the European VAT Directive.

Loans to Originator

Latvian CIT law states that all loans to related parties with certain exceptions are considered deemed profit distributions. Thus, if SPV and Originator are both CIT taxpayers and related parties and if loan transactions take place, additional CIT might be payable.

Dividends

Dividends are included into CIT taxable base and taxed at 20/80 rate. There is no withholding tax on dividends, except if they are paid to persons established in low or zero-tax territories (20% withholding tax applies).

5.6.4 Bond issuance

Domestic law exemption from PIT on interest paid to non-Latvian resident individual investors for the publicly traded securities should be extended to include also to interest paid for covered bonds and ABS to individuals.

[36] Value Added Tax Law, Article 52 (1) (21)

[37] Value Added Tax Law, Article 52(1)(21) a)

Value added tax

Creation and issuance of securities, including bonds, is exempt from VAT.[38] Dealings in securities are in general exempt from VAT.

Income taxes

Taxation of interest sourced in Latvia depends on the tax residency and form (legal entities or individuals) of a recipient:

- Interest earned by Latvian tax resident legal entities and individuals is generally subject to 20/80 CIT (upon profit distribution) and 20% PIT respectively;
- There is no withholding tax on interest paid to non-Latvian resident corporate entities, except if they are paid to persons established in low or zero-tax territories (20% withholding tax applies);
- Interest earned by non-Latvian resident individuals is subject to 20% PIT withheld in Latvia, unless a particular double tax treaty provides for a reduced withholding tax rate or an exemption.

Interest income from publicly traded financial instruments are exempt from PIT for non-resident individuals.[39] Such an exemption may be extended in order for the covered bonds and ABS to be exempt from Latvian PIT for individuals.

5.7 Issues in relation to existing Latvian regulation that may require amendments

Taking into account the considerations described above, in addition to implementing the New Covered Bond and Securitization Law, at least the following issues should be analysed in relation to current Latvian legislation whether additional amendments to specific Latvian laws need to be introduced or specific regulations should be included in the New Covered Bond and Securitization Law (which as special law will prevail over general Latvian laws), if the SPV model is chosen for the covered bonds and securitizations programmes (as applicable). Please note that this table indicates only the major issues that should be analysed, as well as listing respective laws below does not automatically mean that amendments in these laws must be introduced or respective provisions must be included in the New Covered Bond and Securitization Law; these are issues that require further analysis during the law drafting process and alignment of the views of all stakeholders.

[38] Value Added Tax Law, Article 52(1)(21) c)
[39] Personal Income Tax Law, Article 3 (3) (11)

ISSUE FOR CONSIDERATION	EXISTING SITUATION	ISSUE TO BE ANALYSED AT FURTHER STAGE
Banking secrecy	Under Article 61 of the Credit Institutions Law the bank guarantees, amongst other, its clients and their transaction confidentiality (bank secrecy). Further Articles 62 and 63 list exemptions when then bank is allowed to disclose the information subject to banking secrecy. Covered bond programmes, in particular, information transfer to SPV is not listed as one of the exemptions.	It should be considered whether the following amendments need to be introduced: - that the transferring of clients' information associated with the loans from the bank to SPV (without client's express consent) does not result in breach of bank secrecy regulation; - that SPV must ensure the confidentiality in respect to the clients' information, which relates to loans that are included in the Cover Pool and is subject to banking secrecy.
Notification to debtors	Pursuant to Article 1804 of the Civil Law before the debtor has been properly notified about the assignment the debtor (i.e., borrower) may pay debt to the initial creditor (i.e., bank), the debtor also has rights to enter into settlement with the initial creditor. Furthermore, pursuant to Article 98 of the Regulations of the Cabinet of the Ministers No 691 regarding consumer crediting the consumer creditor notifies the debtor about the assignment.	It should be considered whether the following amendment needs to be introduced providing that at the assignment of claims from the bank to SPV, instead of individual notification as required under the Civil Law, no notifications are made and the bank's clients still continue to see the bank as their creditor, until the banks insolvency (if it occurs). In case of insolvency of the bank, the possibility to use public notification would allow to decrease the administrative burden for banks in respect of business transfer, hence introduction of such solution should be considered. Furthermore, the public notification should override the requirement of separate notification specifically agreed upon in assigned claim or transferred contract.

Extraction of cover pool from the field of competence of banks insolvency administrator/liquidator	There are no Credit Institutions Law provisions in relation to covered bonds in case of bank insolvency, (e.g., there are no special rules that ensure segregation of Cover Pool assets, in particular ensure segregation of funds received from the borrowers and used for SPV loan re-payments). Besides, pursuant to Article 173 of the Credit Institutions Law the administrator is entitled to challenge bank's transactions concluded 5 years before bank's insolvency.	It should be considered whether there is a necessity to introduce amendments ensuring that in bank's insolvency scenario the Special administrator has complete discretion to act in relation to the assets in the SPV/Cover Pool, while the bank's creditors and administrator, and liquidator has no control over those assets, as well as the bank's administrator's rights to challenge transaction related to establishment of the Cover Pool and replacement of assets forming Cover Pool (in case the assets included in the Cover Pool initially deteriorate) should be limited or even non-existent.
Special treatment for covered bond programmes in case of recovery and resolution of credit institutions	There are no provisions in the Law on the Recovery and Resolution of Credit Institutions and Investment Broker Firms in relation to covered bonds dealing with bank recovery or resolution, if that relevant bank has issued a covered bond program (e.g., there are no special rules that ensure segregation of Cover Pool assets, in particular ensure segregation of funds received from the borrowers and used for SPV loan re-payments).	It should be considered whether a rule which provides that in the case of bank resolution the resolution authority has no control of the SPV's and Cover Pool's assets, but instead the Special administrator has full discretion in this regard, should be introduced. Aim would be to ensure that the claims of the bank as initial creditor and SPV are completely segregated.
Special protection to the SPV in case of insolvency	The banks are protected from the abuse of the insolvency process by bad faith creditors filing unfounded insolvency applications with the court. Such protection is not granted to SPV.	As the SPV is a part of the banking group and holds the Cover Pool, it should be considered whether mechanisms limiting creditor's ability to initiate SPV's insolvency is needed, e.g., by requesting the creditor to file the application at first to the FSA and giving the FSA discretion to decide whether there is basis for filing the application with the court to initiate insolvency proceedings of SPV.
Use of set-off	Under Article 1808 of the Civil Law after the assignment: (i) the debtor may set-off its claims against the initial creditor (e.g.,	It should be considered whether the debtor notification is needed and practical until the cover bond program operates normally and the bank is

	bank) that were due at the moment of the notification and (ii) the debtor has the right to raise against the assignee (the new creditor, i.e., SPV) all the defences which it was entitled to raise against the assignor at the time of receiving the notification on assignment of a claim.	solvent, i.e., whether the notification to borrowers and security providers can be postponed until the bank becomes insolvent or faces financial difficulties (if these occurrences take place at all). Additionally it should be analysed whether there is a need to introduce exemption to Article 1808 of the Civil Law in relation to claims assigned from the initial creditor (e.g., bank) to SPV, especially, limiting set-off rights and rights to raise defences in relation to claims against that initial creditor. Usually the aim of such measure is to endorse covered bonds and securitisations that the claims of the initial creditor and SPV are completely segregated. This would give more security for the covered bond holders as the claims included in the Cover Pool would not be eroded by set-offs. This is also a principle followed by many jurisdictions. At the same time it has to be analysed whether such limitations on set-off would be justified from bank's borrower's perspective. From practical perspective this might not be an issue, as in case of bank's insolvency the borrower is largely protected by the depositors' guarantee scheme. If the bank is still solvent the bank can take the relevant loan out of the Cover Pool and accept the borrower's request for set-off.
Transactions between related parties	Chapter 6 (Articles 184^1 and 184^2) of the Commercial Law defines the transactions between related parties and requirements for transactions between related parties. Non-fulfilment of these Commercial Law requirements may trigger that the transaction between the bank as initial creditor and SPV (who is a daughter company of the initial creditor) is void.	It should be considered whether the exemption should be introduced from the regulation of "transactions between related parties" in respect to the asset transfer between the bank and the SPV within covered bonds and securitizations programmes. Aim would to simplify the assignment of claims from the parent company (e.g., bank) to the SPV, in particular to alleviate the administrative burden on formally proving that the transaction is beneficial to the parent company (e.g.,

		bank). In case of banks creation of covered bond program and transfer of assets in any event would be subject to the approval of the FSA and accordingly subject to a material evaluation and scrutiny not only from the banks, but also from the FSA's side. Presumably FSA in the first place would require that the transaction is beneficial to the bank as parent.
Limitations on bank's activities via interim measures do not affect cover pool	Pursuant to Article 138 of the Civil Procedure Law interim measures (preliminary injunction), amongst other, are pledge on the defendant's accounts or payments received from the third parties, prohibition to carry out certain activities.	It should be considered whether a rule which ensures that any interim measures - limitations imposed on bank's activities - cannot affect operation of SPV need to be introduced. Aim would be to ensure that the claims of the bank as initial creditor and SPV are completely segregated.
Re-registration of mortgages	Registrations in the Land Register is done piece-by-piece basis. Notary need to be involved for request submission to the Land Register (Article 56[1] of the Land Registries Law lists exemptions when the request may be submitted electronically without notary's involvement, one of these events is bank reorganisation). Land Registries Law does not contain provisions on simple list submission and subsequent security interest reregistration, if such re-registration is needed.	It should be considered whether a solution can be introduced whereunder re-registration of mortgages occurs only in case the bank becomes insolvent or faces financial difficulties. This approach might allow to avoid from excessive administrative burden and/or helps to become cost efficient. In case the above approach is accepted, it has to be analysed whether the additional rules need to be introduced that facilitate simple, efficient and cost effective transfer of security interests, which are associated with the claims assigned from the bank to the SPV, including situations when the security interests are transferred between two countries on a pan-Baltic level. one-off action for re-registration/or simple list submission of pool (or bulks) of assigned registered security interests only in case this is mandatory needed. Also the Aim would be ease the assignment of claims from the bank to the SPV. Please also note that the above described issues apply not only to securities, but

		also to prohibition notes that are recorded in the Land Register. From the initial discussions with the stakeholders we understand that there are technical limits and practical aspects that have to be considered and complete automation might not be possible, however, there are possibilities that should be explored in more details to make the process more cost efficient and reduce administrative burden for the banks, SPVs and the Land Register.
Re-registration of commercial pledges	Registrations in the Pledge Register is done piece-by-piece basis. Commercial Pledge Law does not contain provisions on simple list submission and subsequent security reregistration, if such re-registration is needed. Besides, the Regulations of the Cabinet of the Ministers No 13 regarding the state fees for the registrations with the Pledge Register does not provide reduced fees for such proposed scenario where simple list submission or registration in bulk takes place.	It should be considered whether a solution can be introduced whereunder re-registration of commercial pledges occurs only in case the bank becomes insolvent or faces financial difficulties. This approach might allow to avoid from excessive administrative burden and/or helps to become cost efficient. In case the above approach is accepted, it has to be analysed whether the additional rules need to be introduced that facilitate simple, efficient and cost effective transfer of security interests, which are associated with the claims assigned from the bank to the SPV. Re-registration of security interests in case of bank's insolvency would allow to perform one-off action for re-registration/or simple list submission of pool (or bulks) of assigned registered security interests only in case this is mandatory needed. Also the reversing of asset transfer asset-by-asset (in case of replacement of those claims that have deteriorated and no longer meet criteria of covered bond program) or in bulk (in case in issuing bank is insolvent and the covered bond program is taken over by another bank) can be managed in more efficient manner, as these transfers prior to the bank's insolvency will not be done in the Pledge Register, but in registers/lists kept by the FCMC (the

		rules for relevant record keeping needs to be developed further). Aim would be ease the assignment of claims from the bank to the SPV and to avoid that each time the security interest is registered with the Pledge Register on piece-by-piece basis. Please see section 5.3.3 for more details.
SPV's right to receive insurance indemnity	There are no legal mechanisms in place enabling SPV to automatically receive insurance indemnity payments due to damage or destruction of assets included in the Cover Pool. For transfer of right to receive insurance indemnity as a minimum insurer should be notified. Some general terms and conditions of insurance products provide that substitution of bank with SPV is a basis for insurer to unilaterally terminate the insurance contract.	It has to be analysed whether any provisions that deal with payment of insurance indemnity to the SPV due to damage or destruction of assets included in the Cover Pool are needed. In the alternative, this matter could be addressed by different measures, e.g., the loan can be extracted from the Cover Pool and replaced by another one prior to the insolvency of the bank; the matter becomes more complex if the bank is insolvent.
Data Protection	At this point Latvian law does not contain special rules regarding processing and sharing of personal data in the covered bond programmes.	It should be considered whether the transfer of assets from bank to the SPV should be stated as one of statutory grounds for processing of personal data (insofar as any personal data processing even takes place), whereby the express consent from individuals for transfer and processing of their personal data would be no longer needed. The amendments might be introduced in the Data Protection Law or the New Covered Bonds Law.
Licencing for consumer crediting	Pursuant to Article 8 of the Consumer Rights Protection Law a licence for providing consumer crediting services is required.	It should be analysed whether any activities of SPVs fall under the scope of consumer credit provision. If it turns out that consumer credit licence is needed, then the law would need to be adjusted so that there is an exclusion to the general rule and no licencing is needed or simplified licencing procedure is available for the SPV. If additional loan needs to be issued,

		then the practical solution could be extracting the relevant loan from the Cover Pool and then it has to be discussed whether it will be replaced with another loan or the increased initial loan is put back in the Cover Pool. Aim would be to ease the SPV establishment for covered bonds or securitization programmes.
Extrajudicial recovery of debt	Pursuant to Article 5 of the Law On Extrajudicial Recovery of Debt a licence for providing extrajudicial (our-of-court) recovery of the debt is required.	It should be analysed whether any activities of SPVs fall under the scope of extrajudicial recovery of debt services. If it turns out that extrajudicial recovery of debt services licence is needed, then the law would need to be adjusted so that there is an exclusion to the general rule and no licencing is needed or simplified licencing procedure is available for the SPV. Aim would be to ease the SPV establishment for covered bonds or securitization programmes.
Cost efficiency	Currently Latvian law does not provide for any preferential treatment to the SPVs that are established for cover bond issue.	It should be analysed whether there are any possibilities to reduce the cost base by providing cheaper and less administratively burdening solutions to the operations of the SPV, for example, simplified registration process with the Commercial Register and smaller amount of subsequent notification/reporting/information requirements throughout the life of SPV, as well as lighter requirements towards auditing (if any). The cost efficiency on one hand is affected by the steps taken by the SPV and bank, however, it might be useful to explore the options of following the practice of other jurisdictions to decrease administrative burden in order to ensure that issuing cover bonds in Latvia is competitive.

Credit Register and receipt of information via the Credit Bureau	Currently the law does not provide for an option that issuing bank could report and receive information regarding the exposures to the Credit Register on behalf of SPV (as of the moment when the relevant claim is included in the Cover Pool the bank is no longer creditor/provider of credit services). Also there is no special mechanism how SPV could receive information via Credit Bureau in those cases when receipt of such information is objectively needed.	It should be analysed whether a mechanism could be put in place allowing the bank to report and receive information on behalf of SPV regarding exposures included in the Cover Pool.
Financial collateral	SPV is currently not listed amongst the entities that can be a party to a financial collateral contract, hence at the transfer of claim to the SPV financial collateral is no longer valid. The initial analysis of Article 1 of the Financial Collateral Directive shows that expansion of the list of persons entitled to take financial collaterals is not possible.	It should be considered whether there are legal mechanisms how to prevent the financial collateral from becoming invalid upon assignment of claim to the Cover Pool. Also the economic relevance of this issue should be analysed, i.e., whether this is critical for successful covered bonds programme.
Large exposures	As is common in many covered bond jurisdictions, the FSA will need to notify the European Banking Authority that the bank's exposure to the SPV will be exempt from the rules in the capital requirements regulations which limit the exposure of credit institutions to so called 'large exposures'. The loan made by issuer to SPV (to buy the mortgages) would otherwise constitute a large exposure for these purposes. There are specific carve outs in the CRR rules on large exposures for exposures to SPVs in covered bond programmes. These are based	To be analysed whether complete notification process is needed or certain exceptions might be acceptable.

	on risk mitigants inherent in the covered bond structure. This notification is made under Article 400(3) of the CRR.	
Further legislative steps in respect of the Law on Mortgage Bonds	Latvian law facilitates the issuing of mortgage bonds, however, in practise this instrument is rarely used - until this date only one bank has attempted to test the issue of mortgaged bonds in Latvia, and no bonds remain outstanding at the moment. The Law on Mortgage Bonds, which had the latest amendments in 2006, is outdated.	It should be analysed whether the law should be repealed since the regulation for securitization and covered bonds will be introduced by the New Covered Bond and Securitization Law.
Corporate income tax law	According to current Corporate income tax (CIT) law the SPV as a separate corporate entity will be CIT payer. All transactions with related parties must be arm's length, otherwise any adjustments to the arm's length remuneration shall be included into the CIT taxable base. Requirements towards the taxpayers to prepare the transfer pricing documentation are burdensome.	In order to ensure that no excessive CIT is incurred due to the structure of the covered bonds and securitisation instruments, we suggest amending the CIT law to state that SPVs are not considered CIT payers in Latvia and transfer pricing requirements are not applicable in transactions between the bank and the SPV.
Personal income tax law	Pursuant to Latvian Personal income tax (PIT) law interest for the publicly traded securities for Latvian tax resident individuals is subject to PIT withholding. Interest for the publicly traded securities for non-resident individuals is not subject to Latvian PIT. Besides administrative procedure of determining tax residency of individuals is burdensome.	It should be analysed whether exemption from PIT on interest for the publicly traded securities applicable to non-resident individual investors should be extended to apply also to Latvian tax resident individuals need to be introduced.

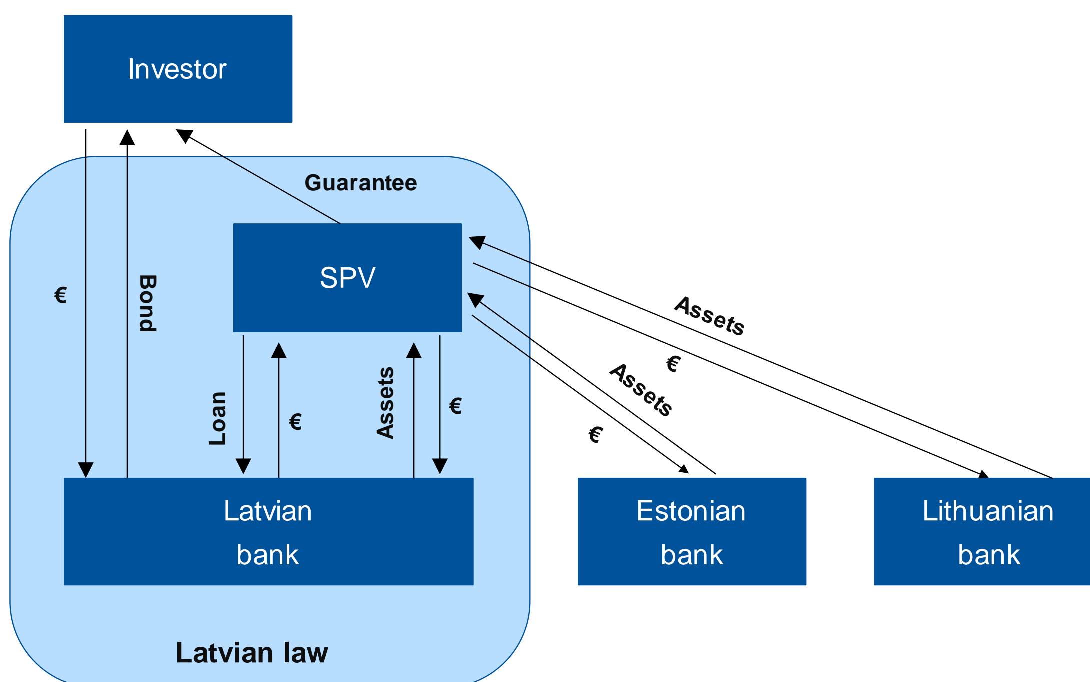
6 Pan-Baltic issuance of covered bonds

Creation of Pan-Baltic market and harmonising of legislation of all 3 Baltic States is addressed in more detail in a separate document - Interim Report of Introduction of Pan-Baltic Covered Bond Legal and Regulatory Framework. This Interim Report addresses issues related to possibilities to use assets located in another jurisdiction, inter alia, whether and how covered bonds issuer from another EEA Member State can use assets located in Latvia (either in its Latvian branch or in a separate Latvian bank) regardless whether covered bonds are issued under SPV model or OBS model.

6.1 Pan-Baltic level structure

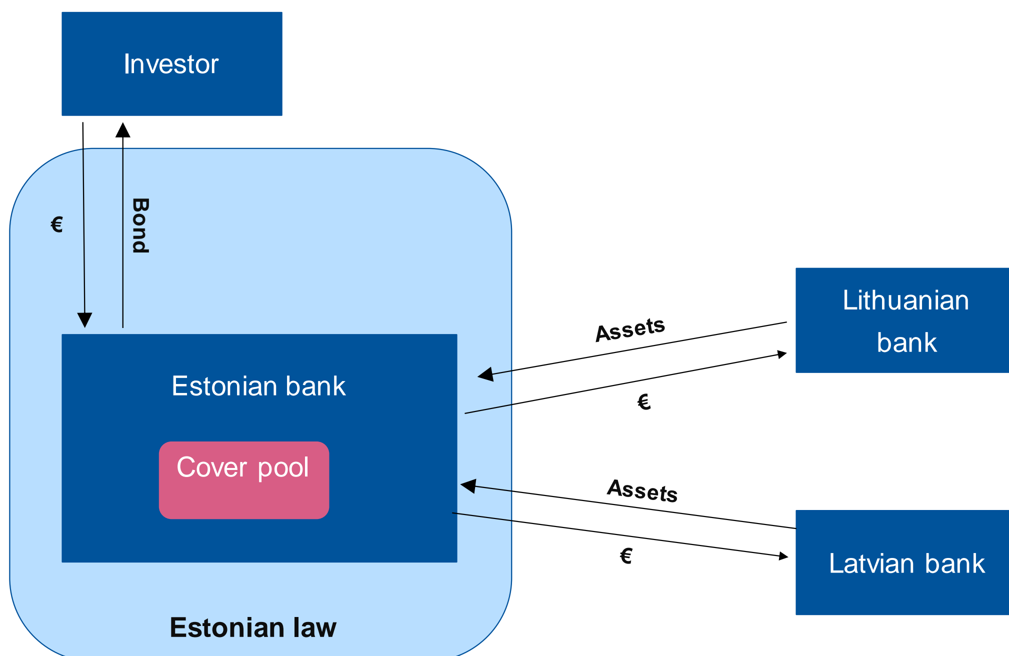
In addition to the structuring within Latvia (and Estonia and Lithuania) an overall framework is required to achieve pan-Baltic covered bonds issuance.

We propose the following structure:



A covered bond programme with a Cover Pool held by an SPV is established in one country – Latvia in the above illustration. Assets from the other two states are transferred into the Cover Pool in that country in return for a payment from the SPV and are used as the basis for a guarantee of a bond issued by the Latvian bank. The SPV borrows the proceeds of the bond issue from the Latvian bank to pay for the assets which it acquires. The SPV (where relevant) holding the Cover Pool should be established in the same country as the Issuer (bank). The SPV (or in Estonia – the bank) pays a share of the consideration it has received for the bonds to the issuing bank and also to the other two banks, since all of the banks participated in the financing of the bond issue.

In the case of Estonia the following structure would apply.



Some of the implications of this structure are:

(i) Each state will have its own covered bond law and secondary regulations. In each country the law should allow assets to be included in the Cover Pool from all three states and assets to be transferred into the Cover Pool in other countries.

(ii) Certain laws and regulations should be identical to the greatest possible extent. Areas which will need to be harmonised include (but are not limited to):

- facilitating cross-border asset transfer, i.e. there are no restrictions on cross-border asset transfers,
- asset eligibility criteria,
- risk mitigation measures such as minimum holdings of liquidity assets, minimum Over-collateralisation, maximum loan-to-value ratios and valuation methodologies,
- criteria for third-parties involved in the structure, for example, derivative counterparties[40] back-up Servicers, Cover Pool Monitors, Special Administrators, etc.,
- single supervisory authority for the covered bond Issuers and SPVs,
- harmonized legal requirements to be authorised to issue covered bonds (either in the form of licensing or in the form of admitting to the register of covered bond Issuers and to regulated covered bonds programmes),
- similar supervisory fees in Estonia, Latvia and Lithuania to avoid selecting the jurisdiction for covered bond issue based on difference in supervisory fees,
- ensuring tax neutrality in respect of cross border asset transfer.

[40] Derivative counterparties in covered bonds typically swap the interest rates received on the assets for those paid on the bonds in order to hedge the SPV. They can be either third parties or group companies.

The provided list above is additional to the issues, which are relevant equally at local and Pan-Baltic level, such as:

- ensuring that there are simplified (including cost-wise) re-registration for the security interests included in the pool of assets,
- no authorisation requirements for the SPVs (where SPV model is chosen),
- no impact on the borrowers' rights (data protection, bank secrecy, consumer rights, direct debiting of payments under loan agreement remains in place, i.e., the loan is still serviced by the bank having granted the loan, etc.),
- no requirements to receive consent from and provide notification to the borrowers and third parties concerned (except derivative counterparties) due to asset transfer,
- carve-outs from insolvency regulation, implementation of true sale (as opposed to creating security interest) principle, etc.

6.2 Facilitating cross-border asset transfer

6.2.1 Precedent for the model and asset transfer

Most covered bond jurisdictions explicitly allow assets from other countries to be included in Cover Pools in their covered bond law. Most frequently this is restricted to EEA member states. Although allowed by law, only few jurisdictions have developed accompanying secondary regulations for assets other than those in their own country – for example specifying valuation methodologies for loans in other countries.

The vast majority of covered bond programmes do not use this functionality and restrict themselves, either by covenant or in practice to assets from one country.

Of the covered bond programmes that do fund assets in more than one country a very high proportion fund ship, public sector or commercial mortgages in more than one state.

The European Commission in autumn 2015 undertook an open market consultation on the covered bond market. One of the topics that they questioned was the lack of cross-border Cover Pools and the impediments that existed to their formation. Market feedback, in particular from investors, was that there was opposition to the unrestricted combination of assets in Cover Pools from more than one jurisdiction unless those jurisdictions were considered to be of very similar credit quality.

Other models are used in the covered bond market to combine assets from more than one bank and could conceivably be amended to allow cross border pooling of assets. The most numerically prevalent model is that used in Spain where several banks issue bonds with the same terms on the same day. These bonds are then purchased by an entity which issues a bond to end investors secured on all of the individual bonds. We have rejected this model for the current project primarily as it would have required far higher upfront costs (an Issuer present in all three countries would need to issue four bonds, one from each country and one from the SPV that combines them).

The above considerations further confirm the necessity for the three Baltic states to harmonize the covered bond regulation in the material aspects.

6.2.2 Asset transfer mechanics

It must be possible to legally transfer the loans, mortgages and any associated rights of the borrower to a third party either at the inception of the transaction or in the event of a credit related 'trigger' event. The transfer of assets must be relatively straightforward and incur no material new costs such as notarial, the land registry fees or tax. Furthermore the Issuer must be able to remove mortgages from the pool with equal ease – for example if the mortgage becomes ineligible or its credit quality

deteriorates. The fees and procedures for registering the security interest securing the loans should be equivalent (if not identical) between the Baltic states, in order to ensure a level-playing field of covered bonds programmes among the states and prevent forum-shopping for issuing of covered bonds, which is based solely on the technicalities of asset transfer.

Every jurisdiction differs with regard to the optimal legal form of transfer and the law changes which may be needed to facilitate this.

The way in which the underlying assets and security interests are transferred to the Special purpose vehicle (in case of Latvia and Lithuania) or to the bank (in case of Estonia) and the attendant practicalities (for example, the necessary amendments to the land registry) will naturally be entirely a matter for the law of the country of origin of the underlying assets. Whereas we are confident that a valid transfer can be achieved in several jurisdictions it is not practical at this stage to speculate on which jurisdictions and methods of transfer will achieve the commercial objectives of possible users of the law.

6.2.3 Standard terms and conditions and consumer rights

Contractual terms and conditions and consumer and data protection laws vary by country. These will influence both the legal form of the transfer and the arrangements for post-transfer servicing of the assets (including direct debiting of payments under loan agreement). It is important that the borrower is in no way prejudiced by the transfer of their loan to a Cover Pool whether domestically or cross border. It should be analysed further how a mechanism can be put in place allowing to debit the borrower's and/or security provider's account for the benefit of SPV by the bank, for example, in new loan contracts including provision in the loan contracts and security agreements that allow direct debiting for the benefit of SPV (the Cover Pool). Especially it should be considered whether there are any means that can be applied to those contracts that were already concluded certain time before they are transferred to the Cover Pool. It has to be analysed whether legal provisions should be introduced that allow direct debit procedures to continue, or more cumbersome option would be obtaining permission from each borrower/security provider.

6.2.4 Insolvency procedures and enforcement of claims

Whichever jurisdictions are used and whatever method of transfer is chosen, it will be necessary to ensure that local insolvency and resolution procedures do not interfere in the timely exercise of the SPV's rights against the assets. Thus, equivalent carve-outs from insolvency regulations (please refer to section 5.4) should apply in all three Baltic states. For example, an insolvency court should not be able to impose a stay on the exercise of security.

It should be noted that the Bank Recovery and Resolution Directive (Article 44 2(b)) explicitly exempts covered bond liabilities from bail-in. Latvia is bound by the European Council Regulation EC No 1215/2012 of 12 December 2012 (Brussels I bis Regulation). As a result of Brussels I bis Regulation, judgment obtained in a Latvian court is enforceable in other Member States.

We would propose that the law restricts assets in Cover Pools to European Union member states, where the Bank Recovery and Resolution Directive has been fully transposed into national law.

6.3 Asset eligibility criteria

Covered bonds, particularly in newer jurisdictions are mainly secured on residential mortgages. However, Article 129 of the Capital Requirements Regulation, which is the only EU-wide definition of eligible assets, also allows loans secured on commercial property or ships and loans to certain public sector borrowers. Under the proposed new directive other asset classes may be allowed on a national

level subject to certain qualitative criteria. It is not certain at this stage if this proposal will be passed into law or if any member states will make use of this right.

Generally speaking mortgages on properties which are of 'mixed-use', for example combined residential and commercial properties and those which are residential, but of an investment nature (non-owner-occupied properties), are considered to be residential mortgages, but exact definitions are subject to national law.

Whereas residential mortgages are by far the asset class of most relevance to most potential Issuers, there might be some interest in also funding commercial mortgages at some date in the future. We would like to propose that the law is drafted in such a way as to allow any asset class that is permitted according to EU law to be included in the Cover Pool, but that the effort to define secondary regulations and supervisory processes should focus on residential mortgages for the time being. Furthermore, the law should require that Issuers specify at inception the primary asset class for their programme.

Note, the above comments relate to the primary asset class in a Cover Pool. EU legislation also allows some 'technical' assets such as receivables under qualifying derivative transactions and assets held for liquidity purposes. These are defined in more detail currently in Article 129 of the Capital Requirements Regulation.

The above comments are especially significant, when transactions are undertaken in one state, for example, Latvia, and secured not only on local (Latvian) assets, but also on assets from other European Union countries including, but not limited to, Estonia and Lithuania.

Some of the above discussed topics are not materially affected by the location of the assets. For example, the establishment of the SPV, bond issuance, insolvency and taxation – are to a large extent domestic (Latvian) matters. Other topics in the law can easily accommodate foreign assets.

There are, however, some specific implications of the use of non-Latvian assets that should be considered.

6.4 Risk mitigation measures

Such aspects of covered bonds as minimum holdings of liquidity assets, minimum Over-collateralisation, maximum loan-to-value ratios and valuation methodologies, should be harmonised among the Baltic states. Differences in these aspects and criteria would make the pan-Baltic pooling of assets impossible.

Although most residential mortgages in all three countries are currently broadly similar – long-dated, floating rate, pre-payable mortgages with caps on maximum loan-to-value ratios – secondary details such as their net interest margin, repayment rate and the extent of non-standard products may influence, for example, optimal Over-collateralisation levels and the importance of Cover Pool swaps.

There are many practical issues in the secondary regulations that will need to reflect national specificities. For example, secondary rules normally specify the rules for the valuation of the underlying security and loan-to-value ratios. Each country has its own most appropriate way to arrive at these values and the secondary regulations will need to reflect this in each country that might be considered.

As these rules are included in secondary regulations rather than a primary act of the Latvian parliament it will be relatively easy to amend them as and when required.

6.5 Rules for the third parties involved

Successful issuance of covered bonds and operation of covered bonds programmes necessitates involving certain third parties. Such persons include, but are not limited to: Special Administrators

(who administer the pool after the insolvency of the bank), Cover Pool Monitors (who ensure the compliance of the covered bond with the applicable laws and regulations), back-up Servicers (who will service the mortgages if the Originator is considered unable to do so, for example due to a very low credit rating), and derivative counterparties (see footnote40 , above). The activities of these persons impact the covered bonds programmes also in the Pan-Baltic covered bond issuance scenario. Thus, the regulation applicable to the third parties involved in covered bonds programmes shall be harmonised among the Baltic states to the extent possible.

Namely:

- the rights and duties of Special administrators should be in essence identical.
  This means that, e.g., in a situation, where the Cover Pool is located and the bonds are issued in Latvia, there should not be any conflicting regulation of the rights and duties of the insolvency administrator of Estonian bank and Lithuanian bank and Latvian Special administrator;
- the rights and duties of and criteria for Cover Pool Monitors should be similar to the extent possible and one Cover Pool Monitor should be able to act as Cover Pool Monitor even if assets from several countries are included in the Cover Pool;
- the regulation applicable to back-up Servicers (e.g. the providers of debt-collection service, if such are involved) need not be identical, however, it should not create legal contradictions among the Baltic states;
- the eligibility criteria for derivative counterparties and requirement for derivative contracts to be included in the Cover Pool should be aligned

6.6 Supervision of the covered bond Issuers and SPVs

Covered bonds require specific regulation, stress testing, on-going monitoring and authorisation (either in the form of licensing or in the form of admitting to the register of covered bond Issuers and to regulated covered bonds programmes). All of this should be attributed to the supervisory authority of bond Issuer's country (hereinafter the "Primary FSA") and integrated with existing regulatory processes in order to avoid duplication, cost and, potentially, conflict between supervisory processes.

The supervision of potential Issuers of covered bonds (established for example in Lithuania) who operate in Latvia through branches rather than regulated subsidiaries may be problematic in practice. In particular it would require the establishment of a new supervisory relationship by Latvian authorities who may find it onerous to, for example, grant a covered bond issuance license to a bank who they did not previously regulate. Enforcement and penalty rules in the secondary covered bond regulations will require the Latvian regulator to serve an enforcement notice to a foreign entity.

Furthermore there is a potential conflict of interests between the Latvian regulator's duty of care towards covered bond holders and the Primary FSA obligations. This may manifest, for example, in disputes over the necessary level of Over-collateralisation to be included in the pool.

Therefore, there should be implemented a clear principle, that the Primary FSA executes the supervision of the covered bond programme and asset pool.

6.7 Pan-Baltic considerations of tax

Not significantly less attractive than the other two Baltic states

Latvian CIT system provides the benefit of the deferred CIT payment, the same as also in Estonia. Compared with the regular CIT system as applicable in Lithuania, in Latvia the deferred CIT system is more beneficial for the taxpayers which aim at reinvesting the profits.

Since Latvian CIT rate is the same as in Estonia (except regular profit distributions which is taxable with 14% CIT rate in Estonia), in general the Latvian tax burden is not less attractive.

Lithuania is the only country in the Baltics which maintained traditional system where CIT is paid annually. However, Lithuania has the lowest general 15% CIT rate among all three Baltic countries (except the CIT for regular profit distributions, which is lower in Estonia – 14% as mentioned).

Similar to Latvia, Estonia applies CIT on a deferred basis upon distributing profits. The CIT is applied at the rate of 20% (from the gross amount). As an exception, Estonia applies advance CIT payments on the profits earned by the credit institutions active in Estonia. Such CIT rate is 14% and it is levied on a quarterly basis. Assignment of claims by Estonian assignor to related entity (whether to bank or SPV abroad) is not subject to CIT on the level of Estonian assignor as long as the consideration received by the Estonian assignor (whether in the form of money or security) is at the arm’s length. Transferring the claim without a consideration would lead to CIT consequences for the assignor. Although transfer pricing regulations are not applicable to assignment of claims to non-related entities (whether to bank or SPV abroad), the assignor should require the consideration as otherwise the assignment could be taxed with CIT as a gift or non-business payment.

No cross-border tax events

Each country shall also ensure a tax neutral transfer of assets and associated rights (incl. mortgages) to the SPV (or bank, where OBS model is chosen) established in another Baltic country.

Each country shall also abolish any taxes and stamp duties on the transfer of the assets and associated rights (incl. mortgages). This includes state fees and notary fees applicable to the transfer of mortgages.

Since the three Baltic states have concluded bilateral double tax treaties, double taxation in cross border situations with taxpayers resident in these countries is eliminated and taxing rights are divided between the contracting states.

Latvia applies the following withholding taxes on payments made to non-resident corporate entities:

- On management and consulting services – 20% (may be eliminated by applying the double tax treaties);
- On sale of real estate located in Latvia – 3%;
- Any payments to persons established in black-listed jurisdictions – 20%.

Lithuania applies the following withholding taxes on payments made to non-resident corporate entities:

- on sale or lease of real estate located in Lithuania – 15%
- on interest received by foreign entity established outside the European Economic Area or in the country, not having Double Taxation Treaty with Lithuania.

Estonia applies withholding taxes to some payments made to non-resident corporate entities, including a service fee payments to entities established in black-listed jurisdictions (at the rate of 20% from the gross amount). Sale of the real estate located in Estonia is taxed in Estonia at 20% (14%). Capital gains received by non-residents from the sale of real estate located in Estonia is also taxable in Estonia.

Further consideration of this point by all stakeholders is requested.

7 Economics of proposed products

7.1 Cost and benefits of secured funding

Covered bonds would represent the economically most effective form of term funding for Latvian banks in terms of the yield that must be paid to investors, the maturities that would be available and the most robust market access in stress scenarios.

However, there are two potential drawbacks. Firstly, there is no significant pressure for term funding currently for Latvian banks albeit for reasons which are unlikely to persist in the long term. Secondly, the upfront costs of establishing a programme – both internal and external - will be higher than for senior unsecured bonds. Covered bonds that can accept assets also from Lithuania and Estonia would reduce this problem to the extent that the upfront costs could be amortised over a greater potential issuance volume.

Securitisations also have the potential to generate a cost saving for Latvian banks, although this is likely to be lower than the saving available via the covered bond market. The extent that securitisations can reduce the necessary level of regulatory capital for banks will largely depend on the risk retention rules in the STS securitisation directive which are currently being developed by Commission, Parliament and Council in the trilogue process.

Securitisations can potentially significantly reduce the cost of funding for non-bank entities in Latvia.

The extent of the saving due to securitizations for all entities is highly dependent on the nature of the underlying assets.

7.2 Economic benefits of secured funding

Any form of long term funding for a bank is normally more expensive than the funding that they achieve by short term deposits (in the absence of an inverted yield curve). However the total quantum of deposits in any given country is for all practical purposes a fixed amount therefore in total it is unable to fund an expansion of aggregate bank balance sheets. Furthermore deposits are highly price sensitive and likely to adversely react to negative credit developments for a bank – with potentially catastrophic consequences as has been seen in many European bank failures over the course of the financial crisis.

The appropriate comparator for covered bonds is therefore senior unsecured bonds issued by the same banks. Covered bonds compare favourably with these in three main ways:

- Cost of funding. Although it is too early to reliably estimate the lower interest cost for Latvian covered bonds, in general terms in the Euro zone covered bonds have tended to trade at spreads over the risk free rate (for example the yield on German government bonds) of between 40% and 50% of the spread for unsecured bonds of the same Issuer. Currently this ratio is generally lower due to the effects of the European Central Bank's covered bond purchase programme.
- Term of funding. Covered bond investors welcome longer bond maturities than investors in senior unsecured debt. This is partially due to their higher credit rating and partially due to the higher participation of insurance and pension investors in the euro covered bond markets (in part due to the favourable treatment of the product under Solvency 2). Ten year or longer bonds are common in the covered bond market.
- Access to funding in stress scenarios. Covered bonds are frequently the first private sector bonds to be issued after a severe financial shock, whether the shock is to the entire financial system (for example, after the default of Lehmans) or to that particular Issuer (many 'rehabilitating' Portuguese, Spanish and Irish banks for example accessed the covered bond

market before attempting unsecured bond issuance. This resilience is a function of both the higher credit rating of covered bonds and the 'real money' (i.e. unleveraged) nature of the majority of covered bond investors which implies that they have to invest proceeds from maturing bonds back into the market.

- The first two of these conditions also apply to securitisations although, as noted above, it is even more difficult to quantify the benefits in the absence of more concrete information on the asset classes and level of risk retention.

7.3 Current Funding Needs

There is little pressure currently for any form of term funding for Latvian banks. This is a combination of several factors, some of which are likely to persist in the medium term.

(i) **Reliance on parental funding**. Significant levels of funding are currently down-streamed or could be down-streamed from non-Latvian parent banks.
The availability of this funding source is likely to diminish if there are divestments of Latvian banks, in response to (non-Latvian) regulatory pressure to reduce foreign exposure and as the credit quality (and therefore the cost of funds) of Latvian and parent banks continues to converge.

(ii) **Lack of regulatory pressure for term funding**. Despite the financial stability considerations there is currently little pressure on banks to better match asset and liability maturity profiles. This pressure can be of a 'soft' nature – a regulator recommendation that banks improve their access to term funding – or of a 'hard' nature, specifically via the Net Stable Funding Ratio. The current calibration of the NSFR is discriminatory towards covered bonds (due to a higher requirement for stable funding for encumbered mortgages), but we anticipate that this is likely to change in the near future.

7.4 Costs of issuance

The cost of issuing a covered bond is dependent on both the details of the regime chosen (for example the costs of compliance with the supervisory regime) and the strength of the covered bond, therefore the rating uplift that it provides, therefore the spread which will be required by investors.

Programme establishment

The primary external costs when establishing and maintain a covered bond programme are the legal costs, the rating agency costs and the costs of a Cover Pool Monitor / auditor. The primary internal costs are management time and IT development.

Legal cost, depending on issuance, might be in the area of €20,000 - €50,000, and might be bigger if the foreign element requiring foreign law counsel is involved. Rating agency costs could be of the order of €100,000 to initially rate a programme plus an on-going annual fee of €40,000 plus 0.5 basis points for each rated bond issue. This assumes that the Issuer is a subsidiary of a bank currently rated by the agency and that only one rating agency is engaged. A covered bond backed by assets in more than one jurisdiction may require additional costs. The cost of obtaining a rating for a senior unsecured issue for a bank with a rated parent would be likely to be of the order of €25,000.

Internal costs are of course Issuer specific and difficult to quantify. However we would anticipate that the IT costs would be relatively low given the high quality of most Latvian bank's IT systems.

Management time will be marginally higher than for an unsecured bond (requiring for example the input of areas other than treasury and the regular compilation of more detailed reports on the Cover Pool).

Yield to investors

The yield that will be required on the debut Latvian covered bond is difficult to predict in the absence of further information (in particular regarding the degree of parental support for the Issuer's credit rating, if any, and the rating uplift that the covered bond structure would support) and given that current funding conditions are largely affected by and depend on the current asset purchase programme of the Eurosystem, therefore it is highly unlikely to be the funding conditions that prevail when the debut issue is launched.

7.5 Reasons for creating a Pan-Baltic covered bond market

Size

The residential mortgage markets in the Baltic states are, as shown in the below table, significantly smaller than the mortgage markets in the smallest countries which currently have a meaningful covered bond market. If combined the pan-Baltic mortgage market would be of a roughly comparable size to those in Hungary and Slovakia (which have, respectively €2.2bn and €4.2bn of covered bonds currently outstanding).

	Residential mortgages outstanding
Estonia	€ 6.3bn
Latvia	€ 4.5bn
Lithuania	€ 6.1bn
Combined	**€16.9 bn**
For comparison..	
Hungary	€ 14.8bn
Slovakia	€ 19.7bn

Source: European Mortgage Federation

A lack of critical mass is clearly a problem to most capital markets instruments in the region, in particular to the extent that up-front costs have to be amortised over less proceeds. The problem is particularly acute in the case of covered bonds for three main reasons:

(i) **Costs:** the upfront costs of establishing a covered bond programme are significantly greater than those of establishing an unsecured bond programme. Material additional costs include more expensive legal and rating processes and the cost of establishing IT and operational procedures. Whereas the cost saving of a covered bond relative to other forms of term funding is material in terms of basis points, clearly the higher upfront costs imply a higher 'break-even' volume of issuance necessary for the product to be cost effective.

(ii) **Investors:** investors typically view covered bonds as liquid products. The liquidity is largely determined by a certain minimum volume of bonds outstanding.
The importance of liquidity and volumes outstanding is enshrined in many structural features of the market. In particular covered bond indices – against which investors are measured – typically only include bonds with at least 500mn outstanding. Furthermore the prudential treatment of the bonds under EU law and for ECB repo operations is frequently size dependent.

Some of the key 'cut-off' points are as shown in the below table.

Minimum size	
€1bn	• ECB liquidity category 2 for repo purposes
€500mn	• Eligible for tier 1 of bank liquidity ratio • Traditional minimum size for interbank market making • Many investor mandates specify that fund managers can only invest in bonds of at least this size • Eligibility for main covered bond indices, such as the Iboxx covered bond index
€250mn	• Eligible for tier 1 of bank liquidity ratio

Transactions smaller than this by smaller mortgage lenders are possible although they typical require a higher coupon to reflect the lack of liquidity. Furthermore they can only be effectively priced after larger transactions have been launched in the jurisdiction – for example by larger mortgage lenders – to provide pricing 'benchmarks'.

(iii) **Security efficiency:** Covered bonds typically use long maturity amortising assets to secure bullet maturity bonds. As such they inevitably create asset-liability mismatches which in the ordinary course of business are not a concern for investors – who rely on the Issuer for the repayment of the bullet maturity bond.

However, post an Issuer default, investors look to the Cover Pool for repayment of their bonds on their scheduled maturity date and, therefore possible asset-liability mismatches must be considered *ex ante*. The larger the covered bond programme the more bonds of acceptable size and different maturities can be issued, therefore the greater the 'natural' matching of asset and liability pay-down profiles. Larger programmes are therefore more security and cost efficient than smaller programmes.

Corporate structure of banks operating in the region

There is no 'standard' model of a pan-Baltic bank, i.e. banking group operating in the three Baltic states. Some banks operate in only one country, some in all three. Furthermore, some are based in one country and operate in the others via branches, some via subsidiaries. The degree to which treasury operations is centralised in one country varies. Finally, many are owned by non-Baltic bank parents.
Any pan-Baltic covered bond framework must accommodate all of these banking models with as close as possible to equal treatment.

The diversity of corporate structures raises two important points;

(I) Covered bond regulators have a duty of care towards covered bond holders; general bank regulators have a duty of care towards all creditors of the bank. A bank which is regulated in one country (and for example operates in the others mainly via branches) but which issued covered bonds in another country would run significant risks of a conflict of interest between these two regulators. When the covered bonds and the banking group have the same regulator, these conflicts can be more easily managed.
(II) Whilst access to the covered bond market is a net positive to the credit worthiness of the Issuer, it also carries the small additional risk of greater encumbrance of liquid assets. However the benefit of access to stable, term funding in particular in a crisis scenario is much larger. If the costs

and benefits of a covered bond programme were to fall in different jurisdictions (a bank based in country A is more stable due to the pledge of assets from country B) this would be inequitable.

7.6 Success metrics

A successful pan-Baltic covered bond framework is one which both respects national specificities, but achieves a high degree of harmonisation for all stakeholders.

Specifically the framework should be judged on the extent to which it delivers the following benefits:

Issuers

Allows Issuers to combine assets from all three jurisdictions in one Cover Pool and to issue covered bonds secured on this pool in a cost-effective way, but also allow for the bonds issued domestically, with assets from one country, if that is the wish of the Issuer.

In order to be cost-effective it must be possible to: i) transfer assets cross-border without any costs or onerous formalities, ii) issue from whichever of the three countries the bank is either based in or has its main treasury operations currently based in and iii) achieve a similar cost of funds, upfront and on-going costs and security efficiency irrespective of which framework the Issuer choses.

Investors

Investors should be indifferent as to which state the bonds are issued from. They should consider the three states to be interchangeable for portfolio management purposes and trade the bonds under a combined credit line.

To achieve this, the framework backing the bonds will need to achieve a similar degree of investor protection in all three states. This can be measured with reference to rating agency analysis of the degree of 'credit uplift' the covered bond framework provides (that is the potential difference between the rating of the Issuer and the rating of the covered bond). Actual ratings of bonds may differ depending on the rating of the Issuer and the quality of the Cover Pool, but should not differ according to the choice of issue jurisdiction.

Other measures that may be used by investors include the prudential treatment of the securities and the degree of pool transparency, both of which should be identical between all three jurisdictions.

Regulator

Potential conflicts of interest between the lead regulator of a bank and the covered bond regulator – to the extent that they are in different countries – should be avoided.

Mortgage borrowers

Borrowers must be treated identically, irrespective of the country to which their loan may be transferred. For the avoidance of doubt this includes, inter alia, data protection issues, consumer rights, servicing arrangements and ability to undertake changes to their mortgage product.

8 Decisions needed, and next steps

Prior to start drafting the law an initial feedback was received from the Ministry of Finance, the Financial and Capital Market Commission, stock exchange, commercial banks and other stakeholders.

The Ministry of Finance of the Republic of Latvia, based on its bylaws, is vested with the powers to prepare draft laws and other legal acts in a sphere of financial markets policy. Given that the initiative to develop the covered bonds and securitisation framework in Latvia comes from the Ministry of Finance, we would expect that the legislative proposal in relation to covered bonds and securitisation laws will be passed to the Parliament by the Government.

Introduction of a special legal framework - special law - for covered bonds and securitisations would achieve a higher level of legal certainty and benefit the interests of Originators, investors.

The new covered bonds and securitisation framework will impact a number of other Latvian laws. Thus, additionally, to drafting new law on covered bonds and securitization is should be analysed whether additional amendments would be needed to the existing legal acts (or specific provisions need to be introduced in new law thus as special law prevailing over general laws), e.g. the Civil Law, the Credit Institutions Law, the Financial Instruments Market Law, etc. The possible techniques to incorporate the new framework into the existing legislation may be either of the following: (i) changing other laws by a specific provisions of covered bonds and securitisation law or (ii)carving out a specific exception from application of a specific other law in case of covered bonds and securitisations. Either of those legal technics may be used dependent on the case, however, carve-out option is preferable one as allows to avoid a duplication and more easily address subsequent changes.

Secondary legislation to be passed on the basis of the covered bonds and securitisations law would be passed by the Financial and Capital Market Commission.

Appendix 1: European Banking Authority 'Best Practice' recommendations for covered bonds

The below represents a brief summary of the main recommendations. Further details are available at www.eba.europa.eu/documents/10180/534414/EBA+Report+on+EU+Covered+Bond+Frameworks+and+Capital+Treatment.pdf.

1. **Dual recourse.** Covered bond investors should have full recourse to both the Issuer of the bonds (or their insolvency estate on a pari passu basis with other creditors) and to the assets in the Cover Pool.
2. **A. Segregation of the Cover Assets.** Assets in the Cover Pool should be sufficiently segregated and identified. The segregation must be legally binding and enforceable. This should include primary and Substitute Assets and derivatives
3. **B&C. Bankruptcy remoteness.** Payment obligations under the bond should not automatically accelerate in the event of the Issuer's default. Insolvency processes should give priority to covered bond investor's claim over the Cover Pool. The insolvency administrator should be able to take all actions necessary for the realisation of the interests of the covered bond investor
4. **Cover Pools.** The composition of Cover Pools should not materially change through the life of the covered bond. Cover Pools should be generally limited to assets located in the EEA [or, for mortgage assets] the priority claim is legally enforceable in the jurisdiction under consideration.
5. **LTV limits.** The framework should establish maximum loan-to-value limits for assets and standards for monitoring and evaluating the value of the property
6. **Coverage and Over-collateralisation.** All of the liabilities of the programme including liabilities towards derivative counterparties should be covered by assets. There should be a legal/regulatory minimum Over-collateralisation level.
7. **A. Derivatives.** Derivatives should be allowed exclusively for risk hedging purposes and should not be terminated upon Issuer insolvency.

   B. Liquidity. Liquidity risks should be mitigated by means of liquid assets available at all times to cover net out-flows

   C. Stress Testing. Issuers should carry out stress test exercises on the calculation of the coverage requirement.

8. **A. Cover Pool Monitor.** A Cover Pool Monitor should be appointed other than the Issuer's auditor. The regulations should specify the monitor's main responsibilities including the monitoring of all coverage requirements and eligibility tests and the random auditing of the Cover Pool.

   B. Supervision. The competent authority should approve the establishment of a covered bond programme. They should be satisfied that there are adequate operational policies, procedures and controls, the restrictions applicable to an Issuer are met and that the Cover Pool meets the applicable requirements.

   C. Duties of National Authority in Issuer Insolvency. The covered bond framework should provide sufficiently detailed description of the duties and powers of the competent authority are in a scenario of Issuer default.

9. **Scope and Frequency of disclosure**. Covered bond Issuers should disclose aggregate data on the credit risk, market risk and liquidity risk characteristics of the programme and other relevant information including concerning the counterparties involved and the levels of contractual and voluntary Over-collateralisation on at least a quarterly basis.

Appendix 2: Laws and regulations referenced

Capital Requirements Regulation	Regulation (EU) 575/2013 of 26th June 2013
Commission Delegated Regulation (EU)	Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)
Directive 2014/59/EU	**Directive 2014/59/EU** of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council
UCITS	Undertaking for Collective investments in Transferable Securities as defined by the UCITS Directive
UCITS Directive	Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (as amended from time to time)
EBA Best practices	EBA Report on EU Covered Bond Frameworks and Capital Treatment, June 2014
Resolution Directive	Bank Recovery and Resolution Directive 2014/59/EU
European VAT Directive	Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax

Appendix 3: Glossary

Term	Definition
Backup Servicer	Normally, the Originator of a transaction continues servicing the original transaction in both securitisations and covered bonds. In pre-agreed cases the SPV can obtain the authority to bring in a Backup Servicer to replace the Originator as Servicer.
Conditional pass through	Arrangement in covered bonds defined in either contract or statute (currently only in Poland) to address a potential inability of an Issuer in distress to meet covered bond obligations when falling due. Typically specifies that a failure to make a bond repayment on the scheduled maturity date does not constitute an event of default. In such eventuality, the underlying bond converts to a floating rate security after its scheduled maturity date and will be repaid as and when the underlying cover assets can be liquidated for sufficient proceeds to make repayment in full. Used in contrast to Soft bullet and Hard Bullet structures qv.
Contractual over-collateralisation	That amount of Over-collateralisation in a Cover Pool which is included by virtue of contractual obligations voluntarily entered into by the Issuer. It is typically set out in covenants of the bond documents. In the case of covered bonds it is typically in excess of Statutory over-collateralisation. In the case of securitisations typically there is no minimum levels for Statutory over-collateralisation. It is used to support the credit rating treatment of the bonds.
Cover Pool	The assets which constitute the collateral for the bonds (and associated senior obligations, for example to derivative counterparties). Consists of both primary and secondary assets. Typically subject to legal arrangements to segregate them from other assets owned by the Issuer in order to ensure certainty of bondholder claim.
Cover Register	A record, usually with legal status and in a form defined by statute which contains information regarding the assets in the Cover Pool.
Cover Pool Monitor	In covered bond transactions, an individual or entity, independent of both the Issuer as well as the supervisor with responsibilities defined under applicable covered bond law. The main responsibility of a Cover Pool Monitor is to ensure that covered bonds are issued and managed in accordance with the law. Different member states have slightly differing definitions of and titles for this entity.
Coverage Test	In covered bond transactions a test defined in either statute or contract which measures an Issuer's compliance with obligations to maintain a sufficient Cover Pool to support the then outstanding bonds. In securitisation transactions the test is not used as there is no ongoing obligation to change the Cover Pool.

Term	Definition
Credit Enhancement	This is a general term for measures taken by the Originator in a transaction structure to enhance the soundness, credit or ratings of the bonds. Cash collateral, profit retention and third party guarantees may serve as such measures in both covered bonds and securitisations. In the case of securitisations only, subordinated bonds may also serve as Credit Enhancement for more senior ranking bonds.
Hard bullet	A covered bond in which a failure to repay the principal on the scheduled maturity date constitutes an event of default. See also Soft bullet and Conditional pass through.
Issuer	In securitisation transactions it is the SPV which issues the securities to the investors. In context of covered bonds it is the Originator of the assets itself, i.e. the bank.
Liquidity Buffer	In covered bonds a pool of assets, other than Primary assets, typically either cash or assets with a very short term, highly liquid characteristics, held in a Cover Pool in order to ensure that there is sufficient cash available for an Issuer to meet principal and interest payments when they fall due without recourse to the liquidation of Primary assets. In securitisation transactions liquidity assets may be held but their use is far less prevalent due to the lack of a fixed maturity pay-down schedule.
Liquidity Cover Ratio ("LCR")	Rules specifying the assets which must be held by credit institutions in order to mitigate the risk of an inability to meet obligations falling due in stressed market conditions. Defined in the capital requirements regulation and the Commission's Delegated Regulation EU 2015/61 with regard to liquidity coverage requirements for credit institutions. Covered bonds can qualify for categories 1B, 2A or 2B, depending on their characteristics. Securitisations can only qualify for level 2B currently.
Loan to value ratio ("LTV")	With reference to mortgages the ratio between the balance due on a loan (either currently or at the loan's inception) and the value of the property granted as security for the amounts due on that loan.
Mortgage Backed Securities ("MBS")	Typically used to refer to securitisations (in contrast to covered bonds). Also RMBS (Residential MBS) and CMBS (Commercial MBS)
Net Present Value. ("NPV")	In the context of coverage calculations the future value of assets or liabilities discounted according to a methodology typically specified in the national covered bond legislation or regulations.
Over-collateralisation	The difference between the value of the Cover Pool and the value of the liabilities which it acts as security for. Typically calculated on either a nominal or present value basis. Assets and liabilities are defined differently for these purposes in different member states

Term	Definition
Originator	The entity which is assigning assets in the transaction (i.e. the primary owner of the assets).
Pass Through	A payment method where the payments to investors take place in the same time periods and are subject to the same fluctuations as receivables. Applying this method the cash flow regularly collected on receivables is regularly passed through to investors. Typically used in securitisations and, in exceptional circumstances only, in covered bonds.
Primary assets	Those assets which the covered bond programme was established to finance. Distinct from derivatives and substitute or liquidity assets.
Servicer	The entity that collects principal and the interests from the debtors and administers the assets after the transaction has closed. It is a common practise that the Originators are acting as the Servicers, however, exemptions may apply (see Backup Servicer).
Soft bullet	In covered bonds an arrangement defined in contract to address a potential inability of an Issuer in distress to meet covered bond obligations when falling due. Typically specifies that a failure to make a bond repayment on the scheduled maturity date does not constitute an event of default. In such eventuality the underlying bond typically converts to a floating rate security after its scheduled maturity date and will be repaid if the underlying cover assets can be liquidated for sufficient proceeds to make repayment in full up until a pre-determined date, typically one year after the scheduled maturity date. If repayment is not made by this pre-determined date an event of default results. Used in contrast to Conditional pass through and Hard bullet structures qv.
Special Administrator	An entity responsible for the administration of the covered bond pool and programme for the benefit of the covered bond holders after the insolvency of the Issuer or sponsor.
Special Bank	A credit institution established for and limited to the issuance of covered bonds, the acquisition of assets to secure them and limited other ancillary activities. Contrast with SPV.
Special Public Supervision	Supervision of covered bond Issuers, programmes and covered pools undertaken specifically to protect the interests of covered bond holders, over and above the normal supervisory processes for credit institutions.
Special purpose vehicle ("SPV")	An independent legal entity used in some jurisdictions to own assets in order to ensure certainty of legal title for the benefit of bond holders. Contrast with Special Bank.
Statutory over-collateralisation	In covered bonds that amount of Over-collateralisation which is required either by law or by regulations passed by the competent authority for the regulation and supervision of the Issuer.

Term	Definition
Substitute Assets	Assets held in addition to the Primary assets, typically constituting derivatives and assets held for liquidity purposes.
Trustee	A third party appointed to act on behalf of investors.