3.1 ARMENIA

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I. FRAMEWORK

Covered bonds are issued in Armenia according to the Law on Covered Mortgage Bonds (hereinafter Law) adopted in 2008 and majorly reformed in 2018 with expert support from KfW, modernizing the framework in line with international best practices.

Major changes that the reform introduced were:

> regulation of centralized covered bond issuance.

> updated and redefined list of assets eligible for the pool. The Law clearly defines the assets that can be used as substitute assets and what the maximum percentage of such assets in the whole pool may be.

> clarification of the asset valuation and revaluation processes. It introduced rules for the case of a significant collateral value decline. Earlier, a reform on mortgage consumer protection had introduced early repayment rules for mortgage loans that permit yield maintenance indemnities and thus improved the matching of cover assets and liabilities.

> establishment of a public cover asset register and refining the functions of the cover pool controller.

> ensuring the ring-fencing of assets in case of insolvency of issuer (in centralized scenario, that of participants as well) by changing the Law on Bankruptcy of Banks, Credit Organizations, Investment Companies, Investment Fund Managers and Insurance Companies.

II. STRUCTURE OF THE ISSUER

According to the Law, the issuer can be either a bank or a credit organization. Those institutions are regulated and supervised by the Central Bank of Armenia and are subject to license requirement, capital requirement, liquidity requirement etc.

There are two scenarios of covered bond issues: a standard one and a centralized one.

In the standard one the issuer of the covered bonds, an individual bank or credit organization, uses its own assets to create a cover pool and issue the bonds.

In centralized issuance scenario the issuer may use other banks' or credit organizations' (called "participants") mortgage assets as collateral in order to create a cover pool and issue the covered bonds. The cover pool of a centralized issuer consists of refinancing loans to the participants. The mortgage loans posted by the participants to back the refinancing loans must fulfil all the requirements just as if the participants were individual covered bond issuers. The law provides for segregation of assets in case of participant's insolvency and thus the respective pool of mortgage loans backing the refinancing loans are moved from participant's balance sheet to that of central issuer (or to other issuer, including participant as the case may be) without entering the insolvency process.

III. COVER ASSETS

Main assets

The assets that are eligible for covered assets pool are mortgages that comply with the following:

1) the real estate subject to mortgage is located on the territory of the Republic of Armenia, or the security of the mortgage is a right for construction of real estate on the territory of the Republic of Armenia;
2) the mortgage represents a first priority claim on the underlying asset;
3) the amount of the loan at the time of inclusion into the pool does not exceed 70% of the estimated market value of the collateral (real estate);

4) The mortgage contract includes early repayment clause in accordance with the Law on Housing Mortgage Credit.

Substitute assets

Where cover assets are to be removed from the asset pool prior to full fulfilment of obligations on mortgage bonds on grounds listed below, the issuer will have the right to include substitute assets in the pool. However, those assets should not at any time exceed 10% of all the assets. The law clearly defines what those substitute assets can be: cash, bonds issued by or guaranteed for timely payment by the Republic of Armenia, and other assets defined by normative acts of the Central Bank of Armenia.

Limitations

In any case the Law provides for some limitations for derivative instruments which may be used in the asset pool. Only the following derivatives may be used:

1) the derivative serves to reduce asset-liability management risks between cover assets and covered bonds issued;
2) the derivative does not require the cover pool estate to post maintenance margin and observe margin calls;
3) upon insolvency of the issuer the derivative excludes netting for the benefit of the derivative counterparty with other claims against the issuer or other derivatives in the cover;
4) upon insolvency of the issuer the derivative is not terminated.

Removing assets from the asset pool

The asset is removed from the asset pool when the asset is terminated (including early repayment of loan, amortization etc.), the asset has been categorized as non-standard, doubtful or loss according to Armenian legislation, or the asset does not meet the eligibility requirements of the Law on covered bonds. The assets must be substituted by other eligible assets (main or substitute). The assets may be removed from the registry without the obligation to substitute them by other assets only when the removal does not amount to breach of adequacy of cover requirement and the remaining cover assets comply with the requirement of the law on covered bonds.

IV. VALUATION AND LTV CRITERIA

Valuation and revaluation

The valuation of real estate is to be performed by a person who:

- is licensed for real estate valuation in accordance with Armenian legislation
- has at least 2 years of experience
- has not been involved in the process of loan provision
- has a professional liability risk insurance for at least the amount equal to five thousand times the minimum wage

The Central Bank may by its normative acts introduce additional rules and methods for valuation of real estate for the purposes of including them into the cover assets pool. In case the valuation may be performed in more than one way and those provide for different results, the minimum among the results will be taken into account.

The real estate is to be revaluated at least once in three years, and if the real estate has a commercial purpose – once a year.

Besides, the real estate has to be revaluated, by a licensed real estate appraiser or according to real estate price index calculated in the manner prescribed by the Central Bank of Armenia, if the real estate prices have substantially fallen (i.e. more than 10%) in the market.

Loan to Value

The amount of the loan at the time of inclusion into the pool should not exceed 70% of the estimated market value of the collateral (real estate).

If the amount of a mortgage loan registered in the cover pool exceeds 85 percent of current mortgage lending value of collateral (real estate), the issuer may either post additional assets for the excess of 85 percent as additional collateral or reduce the loan amount funded by the cover to 85 percent. In case of posting additional assets, the cash flows derived from these assets do not accrue to the bondholders except for the case of the insolvency of the issuer.

V. ASSET – LIABILITY MANAGEMENT

Covered bonds will be backed by dynamic mortgage pools and hence covered bond programs will be subject to asset-liability mismatches. A number of asset-liability management rules have been introduced to mitigate the associated risks and improve risk transparency.

The amount of outstanding liabilities on mortgage bonds must be backed by adequate cover:

1) the total nominal value of assets within cover pool must be at least equal to the total nominal value of mortgage bonds;
2) the receivable amounts on cover assets must be at least equal to the payable amounts against mortgage bonds;
3) the net present value of cover assets must at any moment exceed at least by 1 percent the net present value of all liabilities on mortgage bonds.

The Central Bank has determined stress-testing methodology for the issuers. For the stress test the yield curve is shifted upwards and downwards based on the volatility of interest rates for selected maturities, but not less than 2%. Stress test horizon is 25 days and the confidence level is defined to be 99%.

The bonds issued should be denominated in the currency in which the cover assets are denominated. The assets comprising a single asset pool should be denominated in the same currency.

The issuer of covered bonds is required to maintain a schedule of cash flows, both actual and expected, on the assets included in the cover pool, which, inter alia, includes information on early repayments and overdue payments. The cash flow information shown in the schedule must allow identifying assets, including mortgages, substitute assets and derivatives from which those cash flows have been received.

The schedule must also include projections regarding future unanticipated payments, namely for early repayments of loans, or early performance of obligations arising out of bonds or derivative instruments.

The outstanding liabilities on covered bonds must be at any moment backed by adequate cover on a present value basis after stress-testing, and the expected duration gap, i.e. expected aggregate duration of assets minus expected aggregate duration of liabilities, must not be lower than 3 months to avoid negative maturity transformation risk.

VI. TRANSPARENCY

The registry

The Central Bank maintains the registry of the cover assets of the covered bond program. The registry maintains information on all the assets comprised in the cover pool, namely:

- for land and building or for the permission for construction – Cadastre number, the duration for the permission for construction, its number and date, land/building address, limitation on use of land, if any;
- for mortgage loans – loan agreement number and date, loan register code, loan ID, purpose of the loan, loan amount, loan currency, repayment schedule and maturity date, annual interest rate, secured asset (real estate) value, borrower identification;
- for covered refinancing loans – information as referred to in point above, in addition segregation rights for the benefit of central issuer in case of centralized issue;
- for derivatives – type of derivatives, nominal amount for each type of contract, intrinsic value of each type of derivatives, market value/net present value of derivatives, as well as information on the transaction counterparty;
- other information defined by the Central Bank normative legal acts.

All parties concerned may have an access to information, contained in the cover register, on collateralization of assets.

Access to other information contained in the cover register is restricted to the Central Bank, to the Cover Pool controller, the issuer and the Mortgage Administrator.

Information constituting banking secrecy, contained in the cover register, can only be disclosed in the manner prescribed by law.

The controller of the pool performs the control of the registry. The controller must give his approval in order for the asset to be registered in the pool. Registration of asset without such approval is void.

Information by the issuer

The issuer must prepare, file to the Central Bank and place on its website monthly statements on issuance of mortgage bonds.

Monthly statements must include information on loans comprising the asset pool and information on the real estate, which is the secured asset for those loans.

In the centralized issuance mode, the monthly statements must in addition provide information on the refinancing loans.

Monthly statements must contain the following aggregate information:

1) information about real estate collateral:
   - Property type
   - Property values
   - Purpose of use
   - Property location
2) Information about assets:
   - Cover assets breakdown by nominal amount, loan amount to property value ratio, maturity, expected duration, seasoning, coupon, interest rate reference rate for floating rate loans, region, purpose of loan, and type of collateral
   - Number and amount of cover assets fully and partially repaid during the reporting period
   - Number and amount of substituted assets during the reporting period
   - Reason of substitution by number and amount of assets during the reporting period
   - Loans with higher than 85 percent loan amount in the cover to property value ratio at the end of the reporting period, which were not substituted

> Size of the corresponding cash collateral account
> Number and amount of assets added to cover pool during the reporting period
> Net present value of assets at the end of the reporting period
> Change in net present value of assets from the last reporting period

3) Information about Derivatives:

> Types of derivatives contracts
> Nominal amount of each type of contract at the end of the reporting period
> Intrinsic value of each type of derivatives at the end of the reporting period
> Change in intrinsic value of derivative portfolio from the last reporting period
> Change in net present value of derivatives from the last reporting period

4) Information about Liabilities:

> Covered bond breakdown by maturity or first call date for bonds with embedded options, type of covered mortgage bond issued (fixed or floating), coupon, and duration
> Net present value of covered bonds

5) Information about assets & liabilities management:

> Nominal coverage test, yield coverage test, duration gap, net present value ratio of assets and liabilities

6) Other information defined by the Central Bank's normative legal acts

The participants must also provide loan-by-loan information on historic and scheduled cash flows as well as other information to the centralized issuer enabling it to fulfil its duties defined by law.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

Controller and its Function

The law provides for the notion of controller of the asset pool and his functions.

The controller of the asset pool is the person whose activity is aimed at protecting the bondholders' rights. He imposes control over the cover register and the adequacy of cover assets to liabilities on mortgage bonds, ensuring the bonds are at all times covered adequately, assets are able to be identified and segregated.

The controller checks the compliance with eligibility requirements of the asset before including it into asset pool. He analyses the real estate valuation reports and may demand that only a part of value of the real estate be included in the asset pool.

As soon as a derivative instrument is registered in the registry, the controller informs all the counterparties of the issuer that have signed a derivative instrument with him.

The controller is also responsible for informing the Central Bank about breaches made by the issuer.

The controller inter alia follows the real estate market prices and when notices a substantial (i.e. more than 10%) fall, requires the issuer to reevaluate the real estate comprised in asset pool.

The law obliges the controller to act in the best interests of the bondholders.

Access to information

The law provides for the necessary access to information by controller. For instance, the issuer is obliged to monthly provide the schedule of cash flows to the controller. The issuer is also obliged to form an expectation of the aggregate duration of assets and liabilities and report the expected aggregate duration gap to the

Cover Pool controller. Concerning the requirement for expected aggregate duration of assets exceeding that of liabilities by 3 months, the issuer is obliged to report on it to the controller at least weekly.

The controller may at any time check all the documents concerning the covered bonds and asset pool maintained by the issuer.

Upon the request by the controller the issuer is obliged to provide information on the payments made on loans, as well as any change concerning the assets that might be of interest for the bond-holders.

Controller requirements and appointment

The controller is appointed by the issuer. Every issuer must have a controller. The controller may control multiple asset pools of the same issuer.

The Law provides for clear eligibility criteria for the controller, to insure the person is bona fide and that there is no conflict of interest.

The Central Bank is to establish the cover pool controller's evaluation procedure and professional adequacy criteria.

Supervision of controller

The controller is supervised by the Central Bank of the Republic of Armenia.

Central Bank supervision

The Central Bank of Armenia is the mega-regulator of the financial sector in the Republic of Armenia, which means CBA is the authority for regulation and supervision of the whole financial sector, including banks and credit organizations.

The Law includes special provisions empowering the Central Bank to supervise banks and credit organizations in the context of covered bond issuance.

Besides the issuers, the Central Bank supervises the controllers as well.

The Central Bank may impose sanctions on issuers and/or its management if:

1) The information contained in the registry is incorrect or inconsistent;
2) The adequacy of cover assets or their eligibility requirements were violated;
3) norms, deadlines and public disclosure procedures on reports were violated, and/or the reports contained untrue or inconsistent information;
4) Issuer did not disclose information subject to disclosure by law on covered bonds;
5) Issuer failed to fulfil an assignment provided by the Central Bank in a manner established the law on covered bonds;
6) provisions of the law on covered bonds, other normative legal acts on its basis and internal statutory acts of Issuer were violated.

Upon discovering such violations, the Central Bank of Armenia may impose warning and order (to cease the violation, to recover etc.), fine (may not exceed 1% of the nominal capital of the issuer), revocation of Administrator's license.

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

The law provides that the issuer may not dispose of the cover assets, except in cases of substituting assets in cases provided by the law. The controller controls that each of the assets may be identified at all times and ensure it can be segregated in case of insolvency of issuer (or a participant, in case of centralized issue).

In case of insolvency or ceasing of license of the issuer, the Central bank appoints a duly qualified mortgage administrator to manage the covered assets.

The mortgage administrator has a fiduciary duty towards the bondholders and is obliged to act in their best interests.

From the moment of ceasing of the license or insolvency decision, the administrator must ensure that all the payment received in connection with covered assets are segregated from issuer's other assets and are paid to a special account opened for these purposes.

The administrator may cease the payments to bondholders or participants for up to three months. In the interests of bondholders, the Central Bank may extend this period for another three months.

In the centralized issuer case, at the time of registration of the refinancing loan by the central issuer in the registry, the first-preference right to the segregated assets in case of participant's insolvency is registered as well. As soon as the participant is insolvent, those assets are segregated and may either be registered on central issuer's name or, by central issuer's consent to another issuer.

The bondholders retain the claim towards the refinancing loans and have the first-preference rights for:

> refinancing loans included in the cover pool and any cash flow deriving from those loans;

> and the mortgage loans which are in the balance sheet of the participant organization and their underlying secured assets (real estate).

The assets included in the centralized issuer's cover pool and their cash flows may be disposed of solely to satisfy the claims of the bondholders and no other creditor of the centralized issuer will have any claims over the assets included in the cover pool and their cash flows until all the claims by bondholders are satisfied. After satisfaction of all the claims by the bondholders, the remaining assets, if any, are returned to the insolvency estate of the insolvent organization for other creditors' claims.

The bondholders are paid on pari passu basis. If the assets comprised in the asset pool are not sufficient to satisfy the claims of bondholders, the latter become unsecured creditors for the purposes of insolvency proceedings for the remaining, unsatisfied part of their claims.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

Armenia is not a member of the European Union and it is developing its own risk-weighting regime for covered bonds.

There is currently no special regulation for the risk weighting for covered bonds. The risk weight for covered bonds corresponds to the standard rules. The assets get 100% risk-weight in case the assets are denominated in AMD and 150% risk-weight if they are denominated in foreign currency.

For the most up-to-date information, please consult the new ECBC Covered Bond Comparative Database webpage on the Covered Bond Label website www.coveredbondlabel.com or via the following QR code: