3.13 ESTONIA

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I. FRAMEWORK

On 13 February 2019, the Estonian Parliament adopted a legislation on covered bonds in Estonia. The law entered into force on 1 March 2019. This is the first legislation that provides the possibility to issue covered bonds in Estonia. In late 2021 amendments to the law – covering (i) implementation of Directive (EU) 2019/2162 of the European Parliament and of the Council of 27 November 2019 (hereinafter Covered Bond Directive or CBD); and (ii) alignment of the covered bond regulation in three Baltic states (Estonia, Latvia and Lithuania) – were adopted.

At the beginning of 2020, the first issue of covered bonds was carried out by an Estonian issuer which also constituted as a first covered bond from the Baltic region. An issue with a maturity date of 5 years in the size of EUR 500 million was carried out by Luminor Bank. The covered bonds were listed on the Irish Stock Exchange on 11 March 2020. Luminor Bank has had three additional issues of covered bonds – in February, March and May 2022 with the respective sizes of EUR 250 million, EUR 500 million and EUR 500 million, all with a maturity of 5 years.

In June 2020, another Estonian Bank – LHV – issued its covered bonds (with a maturity date of 5 years in the size of EUR 250 million), which were also listed on the Irish Stock Exchange. LHV has also had second issue of covered bond since – in August 2020 in the size of EUR 100 million with the maturity date of 3.5 years.

II. STRUCTURE OF THE ISSUER

A credit institution wishing to issue covered bonds must obtain additional authorisation from the Estonian Financial Supervision and Resolution Authority (hereinafter the EFSA) to issue covered bonds. During the initial application for obtaining the additional authorisation, a credit institution shall submit also information on the planned covered bond programme. If an issuer wants – after the grant of an additional authorisation – to issue covered bonds on the basis of a covered bond programme other than that provided for in the initial business plan, the credit institution must submit to the EFSA an application for approval of the new covered bonds programme.

For obtaining the additional authorisation, the credit institution must have in place the technology and other technological tools and systems, security systems, control mechanisms and systems necessary for the issuance of covered bonds and the administration of covered bond portfolios. Moreover, it must have a risk management system that enables the issuer to adequately identify, measure and manage the risks associated with the administration of the covered bond portfolio.

The pool of cover assets will be kept by the issuer itself and it will not be held by a special purpose vehicle (SPV). This means that the issuer has to maintain a separate cover register for both below types of covered bonds. The purpose of the cover register is to collect, systematise and store data about the cover pool required for mortgage covered bonds and mixed asset covered bonds. The register is kept in accordance with the internal rules that state the procedure for entering and deleting assets in the register. The entry of the register states information which is necessary to detect the contract or security that is the basis of the claim. Under the general principle, the issuer does not have an obligation to inform the debtor about the entry of the claim in the cover register, however such notification becomes mandatory once the issuer estimates that it is objectively likely that the separation of a covered bond portfolio will take place.

Lastly, the issuer has to appoint a cover pool monitor, who monitors the performance of the duties of the issuer. In specific, whether the cover pool, cover register, the valuation of immovable properties encumbered with a mortgage securing credit and included in the cover pool, the issuer's risk management and reporting, and the terms and conditions of covered bonds are in compliance with the requirements of law.

III. COVER ASSETS

Primary cover assets

At least 85% of the main collateral of the relevant covered bond portfolio has to comprise of primary cover assets. The law constitutes different primary cover assets for mortgage covered bonds and mixed covered bonds.

First, the primary cover assets of mortgage covered bonds can be only the issuer's claims that arise from a credit granted to a natural person against a mortgage that is established on a residential property situated in the territory of a European Economic Area (hereinafter EAA) country.

The credit that has fallen into default after it has been entered in the cover register, can be taken into account upon calculation of the value of the cover pool in the following proportions:

1) 100 per cent of the value of the credit if it has been in default for less than 90 days;
2) 70 per cent of the value of the credit if it has been in default for at least 90 days and the ratio of the credit to the value of the property securing the mortgage credit is less than 50 per cent;
3) 40 per cent of the value of the credit if it has been in default for at least 90 days and the ratio of the credit to the value of the property securing the mortgage credit is more than 50 per cent;
4) 0 per cent of the value of the credit if it has been in delay for at least 180 days.

Second, the primary cover assets of mixed covered bonds can be only the issuer's claims that arise from the following:

1) a mortgage credit;
2) a housing construction credit – a credit granted to a natural person against a mortgaged residential building plot situated in the territory of an EEA country;
3) a commercial mortgage credit – a credit granted to a legal person against a mortgaged residential property, mortgaged residential building plot or mortgaged commercial immovable property situated in the territory of an EEA country;
4) a credit granted to, or debt securities issued by, an EEA country;
5) a credit granted to, or debt securities issued by, a regional government or local authority of an EEA country;
6) a credit granted to, or debt securities issued by, an EEA country's legal person governed by public law;
7) a credit or debt securities guaranteed by an EEA country or a regional government or local authority of an EEA county.

Substitute collateral

In addition to primary cover assets, the cover pool may consist of substitute collateral. Substitute collateral may be:

1) claims on or guaranteed by central banks within the European System of Central Banks, and central governments, public sector entities, regional governments or local authorities of the Member States of the European Union (hereinafter EU);
2) claims on or guaranteed by third-country central governments and central banks, multilateral development banks and international organisations that qualify for the credit quality step 1[1];

1 A CQS is a simplified and standardized scale of credit quality, mapped to the credit ratings of the largest credit rating agencies. Steps are defined in the Commission Implementing Regulation (EU) 2016/1800 of 11 October 2016 laying down implementing technical standards with regard to the allocation of credit assessments of external credit assessment institutions to an objective scale of credit quality steps in accordance with Directive 2009/138/EC of the European Parliament and of the Council. Moreover, the assessment has to be in accordance with Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

3) claims on or guaranteed by third-country public sector entities, regional governments and local authorities, for which a risk weight has been assigned the same way as for claims on credit institutions and investment firms or central governments and central banks and which qualify for the credit quality step 1 according to the risk weight so assigned;
4) claims specified in clauses 2) and 3), which qualify as a minimum for the credit quality step 2, provided that they do not exceed 20% of the nominal value of the outstanding covered bonds in the covered bond portfolio that they cover;
5) claims on credit institutions and investment firms, which qualify for the credit quality step 1, provided that they do not exceed 15% of the nominal value of the outstanding covered bonds in the covered bond portfolio that they cover;
6) claims on credit institutions and investment firms, which qualify for credit quality step 2, provided that they do not exceed 10% of the nominal value of the outstanding covered bonds in the covered bond portfolio that they cover;
7) claims on credit institutions and investment firms in the European Union with a term to maturity not exceeding 100 days, which qualify as a minimum for credit quality step, provided that they do not exceed 8% of the nominal value of the outstanding covered bonds in the covered bond portfolio that they cover and provided that an issuer has obtained corresponding authorisation from the EFSA for inclusion of such substitute collateral in a cover pool;
8) net claims arising from derivative instruments that meet the conditions provided by law, which cannot be treated as the claims specified in clauses 5) or 6), provided that they do not exceed 15% of the nominal value of the outstanding covered bonds in the covered bond portfolio that they cover;
9) claims specified in clause 7) above, which qualify as a minimum for credit quality step 3, provided that they do not exceed 8% of the nominal value of the outstanding covered bonds in the covered bond portfolio that they cover and provided that an issuer has obtained corresponding authorisation from the EFSA for inclusion of such substitute collateral in a cover pool.

IV. VALUATION AND LTV CRITERIA

Valuation and revaluation

The law states that the valuator of the property standing as security for mortgage credit has to comply with the following requirements:

> has sufficient knowledge, experience and skills;

> be sufficiently independent from the process of deciding on the granting of credit as to provide an objective and impartial assessment of the value of the immovable property.

The requirements for the appraisal of immovable property standing as security are the following:

> the immovable will be valuated according to the good practice of property valuation that is based on uniform and well-established market practice;

> it is in line with the good practice of property valuation;

> the valuator detects and collects all the data necessary for the valuation and analyses all factors affecting the value of the property that is being evaluated;

> the valuation is based on up-to-date and reliable data and based on an in-depth review.

The value of a property standing as security for a mortgage credit entered in the cover register must be regularly reviewed at least once a year and revaluated, if necessary. The purpose of the revaluation of the property is not to obligate the issuer to change the value of the property each time, but to review the property in the portfolio in general and to update it, based on the information available to the issuer, in case there has been a change in the value of the assets.

The value of a property standing as security for a mortgage credit, entered in the cover register, must extraordinarily be reviewed and revaluated, in the event of a significant change in market conditions, and in the event that the information available to the issuer indicates that a significant decline has occurred or is occurring on the national or local real estate market, including if it concerns only one specific property type, residential building type or other narrower category of properties.

Loan-to-Value

The claims of an issuer arising from a mortgage credit may be used as a cover asset of mortgage covered bonds in an amount of up to 70% of the value of the property securing the mortgage credit. Nevertheless, all the issuer's claims arising from the mortgage credit entered in the cover register are included in the cover pool in their entirety.

A mortgage accounting for at least 110% of the issued credit amount must be established on the property securing a mortgage credit to be entered in the cover register. The sum of the mortgage may exceed the value of the property securing the credit.

V. ASSET – LIABILITY MANAGEMENT

An issuer must, at least once every 3 months, perform a stress test on the covered bond portfolio to assess the risks set out in the stress testing methodology according to the internal rules. The managers of the issuer are responsible for ensuring the performance of stress tests. More detailed requirements for the procedure, methodology and purpose of stress testing of covered bond portfolios are established by the regulation of the Minister of Finance adopted on 27 January 2023, which entered into force on 13 February 2023.

If the value of the cover pool, as calculated during the stress test, no longer meets the requirements, the cover assets in the cover register must be increased by the maximum deficiency determined as a result of the stress test. An issuer has a right to hedge the risks deriving from the covered bonds by way of using derivative instruments. The precise conditions for using derivative instruments for hedging purposes follow the requirements of the CBD as well as harmonize such requirements with other Baltic states.

VI. TRANSPARENCY

Covered bonds issued by a credit institution registered in Estonia, which has received additional authorisation from the EFSA, are registered in the Estonian register of securities. The EFSA publishes a decision to grant, amend or revoke an additional authorisation on its website no later than on the business day following the day of making such decision.

In addition to the disclosure obligation arising from other legislation, an issuer must disclose information about covered bond portfolios once a quarter. Information about the first 3 quarters of a year must be disclosed within 20 days of the end of the respective quarter. Information about the fourth quarter must be disclosed within 2 months of the end of the quarter. The disclosed information must be available on the issuer's website about at least the last 5 years.

The following information must be disclosed based on the types of covered bond portfolios:

1) the nominal value and the present value of outstanding covered bonds and of the cover pool;
2) the maturity structure of the covered bonds and the cover pool;
3) the percentage of fixed-interest cover assets in the cover pool and the percentage of fixed-interest covered bonds in the liabilities of the covered bond portfolio;

4) the graduated breakdown of the interest rates on fixed-interest and non-fixed-interest cover assets;

5) the percentage of cover assets denominated in a foreign currency in the cover pool and the percentage of covered bonds denominated in a foreign currency in the liabilities of the covered bond portfolio;

6) the geographical distribution of the value of cover assets, at least to the accuracy of the country, based on the location of the property standing as security for a mortgage credit or commercial mortgage credit, and the location of the debtor or issuer in the case of other cover assets;

7) the distribution of substitute collaterals, in terms of their value, between the types of substitute collateral;

8) the level of the liquidity buffer;

9) the percentage of the amount of substitute collaterals, which have been in default for over 90 days or which the issuer estimates to be doubtful, in the cover pool;

10) the methodology for calculating the ratio between credit and the value of the property standing as security for the credit.

In addition, the percentage of the amount of mortgage credit in the cover pool, which have been in default for over 90 days or which the issuer estimates to be doubtful, must be disclosed in relation to the primary cover assets of mortgage covered bonds.

The following information must be disclosed on the primary cover assets of mixed asset covered bonds:

1) the distribution of debt obligations, in terms of their value, between the types of primary cover assets of mixed asset covered bonds;

2) the percentage of the amount of debt obligations, which have been in default for over 90 days or which the issuer estimates to be doubtful, in the cover pool.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The issuer's general meeting has the authority to appoint a monitor. A monitor is appointed for a term that must not be less than 1 year. The monitor inspects whether the issuer is fulfilling its obligations. The monitor is free to choose when the inspections will be carried out. A trustworthy sworn auditor with an impeccable business reputation and sufficient knowledge and experience may be appointed as a monitor. An audit firm that provides or has provided within the year preceding the appointment as the cover pool monitor the audit service to the issuer cannot be appointed as the monitor.

The duties of a monitor are to verify:

1) the compliance of stress testing of a covered bond portfolio and the changes introduced to the covered bond portfolio as a result of stress testing with requirements;

2) the existence of a sufficient cover pool and its compliance with requirements;

3) the compliance of the maintenance of the cover register with requirements;

4) the compliance of the valuation of immovable properties encumbered with a mortgage securing credit and included in the cover pool with requirements;

5) the compliance of the issuer's risk management and reporting with requirements;

6) the compliance of the terms and conditions of covered bonds with requirements;

7) the existence of an updated plan for separation of the covered bond portfolio and its compliance with the requirements of Estonian legislation.

The monitor notifies the issuer of any deficiencies detected during verification in a format that can be reproduced in writing and sets a reasonable deadline for the elimination of the deficiencies. In case the deficiencies are not fully eliminated by that deadline, the monitor must notify the EFSA.

VIII. ASSIGNMENT OF CLAIMS, SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Estonian legislation foresees regulation for assignment of claims to a credit institution of an EEA country or to a special purpose entity located in an EEA country that has been established for the formation of the cover pool of covered bonds in relation of formation of the cover pool. The regulation also establishes rules for segregation of cover assets which have been assigned as well as protection of such assets against recovery in case of insolvency proceedings of assignor of such claims as well as mitigates the risk of set-off related to the claims related to the cover pool.

In case the issuer is declared bankrupt, a covered bond portfolio shall be considered to be separated from the other assets of the issuer. A cover pool shall not be part of the issuer's bankruptcy estate and a moratorium shall not extend to a covered bond portfolio.

The separation of a covered bond does not affect the rights and obligations arising from covered bonds and the payment obligations attached to covered bonds are not subject to automatic acceleration upon the separation of the covered bond portfolio.

After the separation of a covered bond portfolio, an independent pool of designated assets is formed in which the cover pool and the proceeds received therefrom can only be used to satisfy the claims of the holders of the respective type of covered bonds and of the counterparty to the derivative instrument entered in the corresponding cover register and to cover the expenses related to the management of the covered bond portfolio.

If an issuer is declared bankrupt or the compulsory dissolution of an issuer is decided, a court appoints, on the proposal of the EFSA, a cover pool administrator for covered bond portfolios in the ruling on the bankruptcy or the ruling on the compulsory dissolution. The appointment is necessary to secure the continuance of the operation of the cover bond portfolio, detect the solvency of the portfolio and secure the rights of the owners of cover bonds and derivative counterparties.

Upon the appointment of a cover pool administrator, the right to manage and dispose of covered bond portfolios is transferred to the cover pool administrator. The cover pool administrator shall manage covered bond portfolios with the necessary diligence arising from their nature, and in a manner ensuring that the liabilities arising from covered bonds and from the derivative instruments entered in the cover register are met in the best possible way. To this end, the cover pool administrator has the right to transfer and encumber the cover pool, enter into derivative instruments on the account of the cover pool, and perform other necessary operations.

The cover pool administrator has the right to use the cover pool and the proceeds to be received therefrom to cover the expenses necessary for the management of a covered bond portfolio.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The Estonian legislation is in compliance with the CBD and other relevant legislation and documents related to the CBD.

Prior to issuing covered bonds, an issuer must adapt its risk management system to enable it to adequately identify, measure and manage the risks associated with the administration of the covered bond portfolio.

Issuers: Luminor Bank AS, AS LHV Pank

COVERED BOND LABEL: Luminor Bank AS (1 pool), AS LHV Pank (1 pool).

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: