

3.20 ICELAND

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I. FRAMEWORK

In Iceland, the issuance of covered bonds is governed by the Icelandic Covered Bond Act, which came into force on 20 March 2008 (Lög nr. 11/2008 um sértryggð skuldabréf, hereinafter the “**ICBA**”) and which has been updated four times since, most recently in March 2023 to fully transpose EU directive no. 2019/2162 (the Harmonization Directive) into Icelandic law.

The primary purpose of the ICBA is to set out the general legal framework surrounding the issuance and legal status of covered bonds issued by Icelandic issuers. It is complemented by a regulation issued by the Icelandic Financial Supervisory Authority (Fjármálaeftirlitið, hereinafter the “**FME**”) as rules no. 190/2023 (Reglur um sértryggð skuldabréf nr. 190/2023, hereinafter the “**ICBR**”). The ICBR defines in more detail the criteria for obtaining a covered bond issuance license, the universe of eligible cover pool assets, valuation procedures for eligible cover pool assets, asset and liability management, the form and maintenance of the cover pool register, the status of derivative agreements pertaining to the cover pool and the role of the cover pool inspector (the Independent Inspector, see below).

The ICBA, the ICBR, together with the provisions of the Act on Financial Undertakings no. 161/2002 and the Resolution of Credit Institutions and Securities Firms Act, no. 70/2020, provide the principal legal framework for covered bond issuance by Icelandic issuers, and supersede general Icelandic bankruptcy rules thereby creating the requisite bankruptcy remoteness for such issuances.

II. COVERED BOND LICENCE – EUROPEAN COVERED BONDS (PREMIUM) LABEL

Under the ICBA, the FME grants licenses for the issuance of covered bonds. Such licenses may only be granted to licensed commercial banks, savings banks and credit undertakings. The conditions and other criteria for obtaining such a licence are set out in the ICBA and the ICBR. These include the submission by the prospective issuer of an operating plan, verified by a state authorised public accountant, which demonstrates the issuer’s financial stability and that the issuance is otherwise compliant with the requirements of the ICBA. For a further description of the conditions and criteria please refer to Table 1, below.

Icelandic Covered Bonds issued on the basis of an FME licence and otherwise in accordance with the terms of ICBA and the ICBR meet the requirements to be labelled as European Covered Bond (Premium) under the Harmonization Regulation.

The FME has the right to revoke an already issued licence in cases where the issuer has failed to issue covered bonds within one year of receiving the license, the issuer has obtained the licence on the basis of incorrect information, the issuer has infringed its obligations under the ICBA, or where the FME believes that the issuer no longer meets the conditions for possessing the licence.

> TABLE 1: LICENCE NEEDED TO ISSUE COVERED BONDS - CONDITIONS

Conditions and criteria for the issuance of a covered bond license by the FME under ICBR:

The issuer must supply the FME with the following:

- > a board resolution that the board approves the application for a covered bond license;
- > a description of the framework of the proposed bond issuance, e.g. the size of the proposed programme, bond types, currency of bonds to be issued, derivatives, assets to comprise the cover pool, replacement assets, loan to value ratios, valuation methodologies for the cover pool assets etc.;
- > information about the covered bond registry, e.g. how the issuer will maintain the registry as well as how the registry will be supervised and how segregation of cover pool assets from other issuer assets is achieved;
- > information on whether the issuer intends to convert previously issued bonds used to finance assets, that are eligible as cover pool assets under ICBA, into covered bonds.
- > a three-year business plan, confirmed by a public accountant, demonstrating the issuer's financial stability for that period.
- > information on IT systems to be used in connection with the covered bond issuance.
- > any other information that either the issuer or the FME believe is pertinent to the proposed bond issuance.
- > a written statement by the issuer that it and the issuances will fulfil the requirements made by the ICBA and the ICBR.

III. COVER ASSETS

The ICBA defines those assets classes that are eligible for the Cover Pool. These are:

- > Mortgages secured by residential real estate in member states¹;
- > Mortgages secured by industrial, office or commercial real estate in member states;
- > Mortgages secured by farms and other real estate used for agricultural purposes in member states; and
- > Public sector assets defined as bonds issued by the Icelandic state or other member state, a municipality in Iceland or in another member state, or guaranteed by such public authority.

For a mortgage to be included in the cover pool, all real property (and associated chattels) underlying such mortgages must be fully insured against fire.

The ICBA does not require separate cover pools for mortgage and public sector cover pool assets, and both asset classes can therefore be contained within a single cover pool. Hitherto, Icelandic covered bond issuers have only issued covered bonds where the underlying cover pool comprises exclusively residential mortgages.

Under the ICBA, cover pool assets represent a claim of the covered bond issuer against the relevant borrowers, and these assets remain on the issuer's balance sheet. No subsequent transfer of cover pool assets to another legal entity is required to achieve segregation of the cover pool assets from the issuer's other assets.

Covered bonds issued by Icelandic issuers constitute direct, unconditional obligations against the issuer. Outstanding covered bonds are backed in their entirety by the cover pool. Accordingly, there is no direct legal link between a single cover pool asset and a particular covered bond series. In the event of issuer insolvency,

¹ Member state: a state which is a party to the Agreement on the European Economic Area.

the cover pool is bankruptcy remote from the general insolvent estate of the issuer and exclusively available to meet outstanding claims under the issue of the covered bond investors. Any claim of the bankrupt estate against the cover pool assets is therefore subordinated against claims of the covered bondholders. Should the value of the cover pool assets prove to be insufficient to satisfy claims of investors under the covered bonds, such investors enjoy recourse to the insolvency estate of the issuer, where their claims will rank pari passu with senior unsecured investors. For a further discussion, see chapter X below.

Substitute assets

The ICBA allows for the inclusion of the following assets as Substitute Collateral (Article 6):

- > Demand deposits with a regulated financial undertaking;
- > Deposits with or claims against an EEA member state or a central bank in a member state;
- > Claims against other legal entities which, the FME views as not involving greater risk than the aforementioned options.

Furthermore, FME may approve the following as substitute collateral:

- > Claims against municipalities in EEA member states;
- > Claims against a regulated financial firm other than demand deposits with a regulated financial undertaking (as referred to above), provided the final maturity of such claim is within one year of issuance.

Derivative contracts

The ICBA authorises the use of derivatives for hedging interest, duration, currency risk and other risk factors as needed. The provisions of the ICBR demand that derivatives must be structured such that premature termination is not triggered by an issuer default/reorganisation/bankruptcy of the issuer or by a demand by the counterparty. The ICBA though dictates that the scale of derivatives included in the cover pool may not exceed that what is necessary to maintain adequate balance between assets and liabilities and that derivative agreements shall be cancelled when no longer needed for that purpose.

Furthermore, under the ICBR derivative counterparties must, unless otherwise permitted by the FME, possess a credit rating from a registered credit rating agency which demonstrates its credit quality in either credit quality step 1 or 2 pursuant to regulations (EC) no. 1060/2009 and 2016/1799.

Should the credit rating of such fall below the specified minimum level, the issuer of covered bonds must, under the terms of the derivative contract, be able to:

- > Demand additional collateral;
- > Terminate the derivative contract and establish a new derivative contract with a counterparty that meets the minimum rating requirement, or;
- > Request that the counterparty provides a guarantee from a third party that meets the minimum rating requirement.
- > Claims against non-Icelandic development banks listed in rules adopted by the FME;
- > Claims against other legal entities which do not involve greater risk than the substitute collateral referred to in other items of this paragraph.

It should be noted that substitute collateral may not comprise more than 20% of the value of the cover pool. The FME may however authorise an increase in the proportion of substitute collateral in the cover pool to as much as 30% of its value.

Additionally, article 6(b) of the ICBA states, that in other respects, the assets comprising the cover pool must also meet the criteria set forth by article 129 of regulation (EU) no. 575/2013 which inter alia imposes additional requirements as to the credit quality of the underlying assets.

IV. VALUATION AND LTV CRITERIA

The ICBA defines valuation principles for the properties that are used as cover pool assets (ICBA: Chapter III, Article 7). An assessment of the market value of real estate shall be based on the selling price in recent transactions with comparable properties. By recent transaction it is meant that the transaction used for benchmarking took place within three months of the valuation. If the market value of real estate is not available, it shall be determined by a specific valuation. The valuation shall be based on generally accepted principles for market valuation of real estate. Among the data that can be used as a basis is data on real estate price developments from the Land Registry of Iceland, together with other generally accepted systematic collection of real estate price data.

If an issuer assesses the market value of real estate, the Independent Inspector (as defined below) must verify that the appraisal is based on a generally accepted methodology. The Independent Inspector may re-assess the market price of one or more properties if he/she regards the valuation as incorrect.

An appraisal of the market value of real estate must be in writing and must specify the methodology used, who carried out the appraisal and when it was made.

For the various mortgage types eligible as cover pool assets, the maximum LTV ratios apply (ICBA: Chapter III, Article 7):

- > 80% of the value for real estate.
- > 70% of the value for real estate intended for agricultural use (some restrictions apply).
- > 60% of the value for real estate, where the property is intended for office or commercial use.

V. ASSET AND LIABILITY MANAGEMENT

The ICBA requires that the nominal value of the cover pool assets at all times exceed 105% of the aggregate nominal value of claims arising from outstanding covered bonds against the issuer, taking into account currency fluctuations and the mark-to-market positions of those derivative contracts comprising the cover pool (ICBA: Chapter V, Article 11 and ICBR Chapter IV, Article 5). Article 3 of the ICBR further states, that the value of credit assets, included in the cover pool, but which have been in arrears for more than 90 days may not be counted as a part of the cover pool value when calculating this ratio. Icelandic covered bond issuers have generally undertaken to maintain a level of overcollateralization which is significantly higher than the minimum ratio discussed here.

In addition to the required minimum overcollateralization, ICBR (Chapter IV, Article 6) stipulates that on a net present value (NPV) basis, the cover pool assets, including derivatives, must always exceed the corresponding value of the interest and principal of outstanding covered bonds, taking into account the effects of stress-test scenarios on interest and currency risk set by the ICBR. The ICBR defines the stress test for interest-rate risk as a sudden and sustained parallel shift in the reference curve by 100 bps up and down. The reference curve is based on Icelandic government bonds for covered bonds in Icelandic krona but swap rate curves for other currencies. Likewise, it defines currency risk as a 10% sudden and sustained change in the relevant foreign exchange rate between the currency of covered bonds and the currency of cover pool assets (ICBR: Chapter IV, Articles 6 and 7).

VI. LIQUIDITY MANAGEMENT

The ICBA (ICBA: Chapter V, Article 12(2)) requires an issuer to ensure that the balance between repayments and other cash flows pertaining to the assets of the cover pool and repayments of the covered bonds are

such that payment obligations under the covered bonds and applicable derivative agreements may be met, in addition to the expected cost of winding up its covered bond programme. To ensure compliance with this requirement, the issuer shall maintain all cash flows from the cover pool assets separate from its other funds and assets.

Additionally, the ICBA (ICBA: Chapter II, Article 6(a)) dictates that a cover pool shall always contain sufficient readily available funds to ensure that it is able to meet net maximum cash outflows pertaining to the covered bonds secured by the cover pool and applicable derivatives for the next 180 days. When determining the maximum outflows for these purposes, the issuer may take into account the last possible maturity date of a covered bond which permits maturity date deferral in accordance with the provisions of ICBA, Article 13(b).

ICBR, Article 10, defines the types of assets which shall count as readily available funds for these purposes.

VII. DEFERRAL OF MATURITY DATES

The ICBA (Chapter VI, Article 13) prescribed that either the issuer or an administrator of the issuer's bankrupt estate may, with FME permission, postpone a maturity date of a covered bond, provided that this is necessary to either prevent a default causing the sale of assets at significant discounts, to facilitate the positive outcome of timely interventions by the FME or to maximize covered bondholder recovery during the resolution process of the issuer.

The deferral needs additionally to be based on a clear authority in the terms of the covered bonds and may not upset the sequence of maturity dates of covered bonds that are secured by the same cover pool.

VIII. TRANSPARENCY

The ICBA, (ICBA, Chapter VI., Article 13(a)) requires issuers to publish information on their covered bond programme which shall be sufficient to enable investors to assess the scope and risks associated with the programme. Furthermore, issuers shall quarterly provide information on the value of the cover pool assets and other information needed to assess the risks associated with the cover pool assets, including information on the delinquency rate of the cover pool assets.

IX. COVER POOL MONITOR AND BANKING SUPERVISION

Issuers of covered bonds fall under the supervision of the FME, which monitors the issuers' compliance with the ICBA and other related regulatory provisions (e.g. ICBR). If a covered bond issuer is in a material breach of its obligation under the legal framework, the FME can give the issuer a formal warning or revoke the issue license altogether and in doing so transferring the entire cover pool to a new custodian. The FME may also revoke a license if the institution has declared that it has no intention to use the license to issue covered bonds or if the institution has not made use of the license within a year from the date of receiving the license. The revocation may be combined with an injunction against continuing the operations and with the imposition of a conditional fine. In any case, the FME must determine how the operations should be wound up (ICBA: Chapter IX, Articles 24–29).

Each issuer must appoint an independent and suitably qualified cover pool inspector (the "**Independent Inspector**") and such appointment must be validated by the FME. The duties of the Independent Inspector are to monitor the register and verify that the covered bonds, the derivatives agreements and the cover pool assets are correctly recorded and meet the criteria of the ICBA and the ICBR. The Independent Inspector also ensures compliance with liquidity and risk management in other respects being non-compliant with the ICBA and the ICBR. The issuer is obliged to provide the Independent Inspector with any information requested by the Inspector relating to its covered bond operations. The Independent Inspector must submit a report of the inspection to the FME on an annual basis and must notify the FME as soon as he/she learns about an event deemed to be significant to the supervisory authority (ICBA: Chapter VII, Articles 21–23 and ICBR, Articles 16-18).

X. SEGREGATION OF COVER POOL ASSETS AND BANKRUPTCY REMOTENESS OF COVER POOL ASSETS AND LIABILITIES

Cover Pool Registry

The issuer must keep a detailed registry of the cover pool assets and underlying derivative contracts as well as outstanding covered bonds (ICBA: Chapter VI, Section 13). The law further specifies the form and content of such a registry, which must be easily accessible to the FME and the Independent Inspector.

The registration of the cover pool assets legally secures covered bond holders and derivatives counterparties a priority claim against the assets the cover pool in the event of issuer insolvency (ICBA: Chapter 7, Article 15).

Prior to an issuer being declared insolvent, cash flows accruing from the pool must be accounted for separately by the issuer. In the event of issuer default, covered bond investors and derivative counterparties have the same equal claim against these funds as they have on the cover pool. Moreover, cash flow accruing from the cover pool assets following issuer insolvency must be registered in the cover pool and segregated from the issuer's other assets (ICBA, Chapter V, article 12).

Issuer insolvency

Issuer insolvency, issuer reorganisation or winding-up does not automatically cause its covered bonds to become due and payable (ICBA, Chapter VII, article 14(1)). The same is true for its derivative contracts which form a part of the cover pool assets.

In the event of issuer insolvency, the cover pool assets and the respective covered bonds are segregated from the insolvency estate of the issuer with covered bond holders and registered derivative counterparties having a priority claim by way of a pledge against the cover pool assets and cash that derives from the cover pool, ensuring timely repayment to original agreed terms. It should be noted, however, that the cover pool does not constitute a stand-alone legal entity, separate to that from the bankrupt estate of the issuer. The executor of the bankrupt estate will thereafter act as the administrator of the covered bonds and the cover pool assets. ICBA requires the administrator to maintain the segregation of cover pool assets and other assets which replace them and cash, separate from other assets of the bankrupt estate.

Cover pool insolvency and preferential treatment

In the event that the cover pool breaches eligibility criteria, covered bonds are accelerated. Covered bond investors and derivative counterparties would have priority claim on the proceeds from the sale of the cover pool assets, ranking *pari passu* among themselves. Should the proceeds from the realisation of the cover pool assets prove to be insufficient to satisfy the claims of covered bondholders and derivative counterparties, their residual claims will rank as general, unsecured claims in the winding up of the bankrupt estate.

Survival of Overcollateralization in the Cover Pool

Any overcollateralization present in the cover pool assets at the time of issuer insolvency is bankruptcy remote, provided it is identified in the cover pool register as any other assets. Indeed, the ICBA requires full repayment of outstanding claims on covered bonds and registered derivatives before cover pool assets become available to satisfy claims of the issuer's unsecured creditors.

The ICBA does not provide for the appointment of a special cover pool administrator in case of issuer insolvency.

The executor of the issuer's bankrupt estate shall, in its actions, represent the interest of both the covered bond investors and the unsecured investors. The executor has the right to use any overcollateralization to make advancements to other creditors of the bankrupt issuer provided the cover pool demonstrably contains more assets than are necessary to satisfy all claims of covered bondholders and derivative counterparties. Should for whatever reason cover pool assets later prove to be insufficient for such purposes, any funds released by the executor to other creditors can be reclaimed.

XI. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 of the Capital Requirements Regulation (CRR²). Icelandic covered bonds comply with the criteria of Article 52(4) UCITS and with the covered bond criteria defined in Article 129(1) CRR. The ICBA explicitly lists mortgages against property for agricultural purposes and mortgages against the pledging of tenant-owner rights as eligible cover pool assets, while the CRR does not. In addition, issuers can impose self-restrictions to ensure that their covered bond issues comply with the CRR. Icelandic covered bonds are not eligible for repo transactions with the Icelandic Central Bank.

XII. ADDITIONAL INFORMATION

Legislative covered bonds in Iceland

Arion Bank and Íslandsbanki were both granted a license to issue covered bonds under ICBA in 2011 and both followed up by issuing covered bonds denominated in Icelandic krona to domestic investors. Landsbankinn was granted a license to issue covered bonds in 2013 and issued its first covered bonds in June 2013. The banks use their covered bond programs to fund their residential mortgage portfolios.

In 2021 Arion Bank was the first Icelandic bank to issue EUR dominated covered bonds. Now both Íslandsbanki and Landsbanki have outstanding EUR covered bonds.

Historically most of the mortgages in Iceland were inflation-linked. In recent years there has been a general shift from inflation-linked mortgages to more traditional style fixed rate and floating rate mortgages. The market for mortgages has changed significantly recently with commercial banks being the primary providers of new mortgages replacing the government-owned Housing Financing Fund and domestic pension funds as the primary providers of mortgages.

Issuers: There are currently three issuers of covered bond in Iceland – Arion Bank, Íslandsbanki, and Landsbankinn.



COVERED BOND : Arion Bank (1 pool), Landsbankinn (1 pool).
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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:



² Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): <https://hypos.org/ecbc/covered-bonds/>.