

3.24 LATVIA

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I. FRAMEWORK

A specific regulation for covered bond issuance in Latvia was created only on 27 May 2021 when Latvian Parliament adopted an entirely new law – the Covered Bonds Law (the **Law**). The Law entered into force on 23 June 2021. Continuing implementation of the covered bond issuance regulations, in June 2021 the Financial and Capital Market Commission (**FCMC**) adopted several related regulations on the procedures to obtain the permit for the implementation of a covered bond programme, procedures for selecting a candidate for the office of the special administrator, as well as the reporting on potential and actual violations and financial reporting. As of 1 January 2023 the Bank of Latvia overtook the financial services' sector supervisory functions from the FCMC. Although the Law and corresponding regulations still refers to the FCMC, this is a merely transitional change until the correct references are implemented and de facto the functions relating to the supervision of covered bonds regulation are already fulfilled by the Bank of Latvia.

The Covered Bonds Law

The Law was developed by the Latvian Ministry of Finance in cooperation with the European Bank for Reconstruction and Development (EBRD) and the European Commission (EC) in order to improve and modernize the national covered bond regulation. The Law transposes the Covered Bonds Directive No. 2019/2162 (CBD) and is aligned with the amended CRR. The Law implements the so called "SPV model" where the cover assets of the covered bonds are segregated from the other assets of the credit institution issuing the bonds in a special purpose vehicle. The Law also aims to follow the best market practices of cover bonds regulation.

The Law prescribes the cover portfolio management agreement and the terms of its conclusion. The Law covers covered bonds structure; establishment, operation, liquidation and supervision of the covered bond company (the SPV); cover assets' acquisition and protection from third party claims; insolvency procedure aspects of the issuer, the credit institution transferring the claims included in the covered bond portfolio (the transferor) and the covered bond company; protection of investors and creditors of the covered bonds; public supervision of the operation of covered bond programmes; and operation of cross-border programmes.

Given that it is essential for all three Baltic States (Latvia, Lithuania and Estonia) to create a uniform covered bonds market, which requires ensuring the mutual compatibility of their local legislations, then the main elements of the legislation to the extent possible were aligned during the drafting process amongst all three jurisdictions. The Law is a step closer to create a Pan Baltic (a common Latvian-Lithuanian-Estonian covered bond market) in order to ensure cross-border covered bond issuance, and it intends to provide for the possibility to combine bank assets from all three Baltic States in the cover pool in order to ensure more favourable conditions for the issued bonds in the international market.

In the short period of time the Law has been in force, the covered bonds market potentials in Latvia are only being explored. Currently, there is no fast growth of covered bonds issuance in Latvia. Taking a look on the whole Pan Baltic market, the first covered bond issuance took place in Estonia on March 2020 – only two years ago.

II. STRUCTURE OF THE ISSUER

Under the Law, to operate a covered bond programme and to issue covered bonds, any licensed credit institution registered in Latvia or a foreign (non-EU/EEA) credit institutions' branch in Latvia may apply for the license for covered bond programme operation. If the issuer is a foreign (non-EU/EEA) credit institution' branch, the decision on the establishment of a covered bond company must be made by the foreign (non-EU/EEA) credit institution as a legal person. The license is issued by the FCMC.

The FCMC issues the license for the operation of covered bond programme to the credit institution if it and the proposed covered bond programme fulfils regulatory requirements. For example, the Law expressly lists such criteria as:

- (1) the issuer's obligations to investors and creditors of covered bonds must be secured by a guarantee of the covered bond company (the SPV);
- (2) appropriate accounting procedures and technical arrangements are used ensure the separation of cover assets;
- (3) the issuer has developed and implemented an appropriate, comprehensive, reasonable and effective set of policies, procedures and methodologies for the operation of the covered bond programme, taking into account the type, scope and complexity, including the continuity plan, for the covered bond programme;
- (4) the issuer has ensured that the implementation of the covered bond programme is performed by persons with sufficient qualifications;
- (5) the issuer has implemented and complies with the provisions which provide that the cover assets – tangible property – are adequately insured against losses;
- (6) the results of the stress testing performed by the issuer indicate the observance of the coverage requirements and the required levels of overcollateralisation.

The more detailed procedural aspects on how to apply for the license for covered bond programme operation are laid down by the FCMC regulations (to be replaced by the corresponding regulations by Bank of Latvia), which were adopted for assessing the ability of the issuer to implement the covered bond programme.

The Law also provides for the requirements for establishing and operation of a covered bond company (the SPV). The issuer – a credit institution – may establish the covered bond company. The issuer and the covered bond company must be registered in the same EU member state. The issuer must be a shareholder of a covered bond company. The covered bond company must be established in a form of a limited liability company (in Latvian – *sabiedrība ar ierobežotu atbildību*) or a stock company (in Latvian – *akciju sabiedrība*). The operation of a covered bond company is limited to ensuring its own operation and the fulfilment of the covered bond programme. The covered bond company must be liquidated if the covered bond programme is completed or the covered bond company no longer has cover assets and rights to new cover assets in accordance with the cover pool management agreement. The reorganization, transfer of undertaking or any other action in respect of the covered bond company, if this action would prevent or prejudice the ability of the covered bond company to fulfil its obligations under the provided surety is prohibited, unless it can be shown that such action would not harm the interests of the covered bonds' creditors and investors.

III. COVER ASSETS

The following types of cover assets must be included in the cover pool:

- (1) financial assets that the issuer lends to the covered bonds company (SPV) for the acquisition of primary assets and substitution assets;
- (2) primary assets and substitution assets;
- (3) transaction values of the derivative contracts;
- (4) financial assets which have been acquired from the assets referred to in precious points 2 and 3.

At least 85% of the required cover assets value must consist of primary assets. The Law provides that primary assets consist only of the high quality assets from these particular classes:

- (1) public sector assets indicated in Article 129(1)(a) and (b) of the CRR;

- (2) residential mortgage assets as provided for in Article 129(1)(d) of the CRR;
- (3) commercial mortgage assets as provided for in Article 129(1)(f) of the CRR;
- (4) loans covered by liens on ships as provided for in Article 129(1)(g) of the CRR;
- (5) assets which are loans (credits) to capital companies controlled by a public person or, in cases where the law allows such capital companies to issue loans (credits) or provide guarantees themselves, loans (credits) guaranteed by such capital companies.

Whereas the substitution assets may consist of assets in the form of exposures as per Article 129(1)(c) and (1a)(a),(b),(c) and (d) of the CRR.

In order to ensure the compliance of the cover pool with the requirements specified by law, assets with payments that are overdue for more than 90 days cannot be included in the cover pool. The Law sets out the procedure for determining the value of cover assets related to an outstanding loan in the event of default, i.e. if the debtor delays the repayment of the loan.

IV. VALUATION AND LTV CRITERIA

The issuer must value the underlying assets in accordance with the Commission's requirements for credit risk management, including the applicable valuation standards, and the requirements for the persons entitled to value the assets. The valuation of cover assets must be adjusted in accordance with the indexation of the assets' market value.

For the primary assets that are residential mortgage assets, the LTV (the loan amount ratio to the coverage value) cannot exceed 70%. For the primary assets that are commercial mortgage assets and loans covered by liens on ships, the said ratio cannot exceed 60%. The ratio must be determined for the cover asset on the day when it is included in the cover pool for the first time.

The valuation must be performed at least once a calendar year, unless the terms of the covered bond programme provide for a more frequent valuation or it is required by the Commission, or the cover pool monitor. The methods to be used in the valuation of cover assets and the indexation procedure for the valuation of cover assets must be determined in the terms of the covered bond programme.

V. ASSET – LIABILITY MANAGEMENT

The Law stipulates the conditions for the use of derivative contracts in the cover pool and provides for the obligation to ensure liquidity reserves and stress testing. To ensure that the issuer is able to fulfil its obligations to investors, the issuer is required to replenish the cover pool with new cover assets in the event the stress test result shows that the applicable stress testing scenario does not comply with the required level of overcollateralisation.

The Law stipulates that the issuer performs stress testing at various levels of the financial turmoil at least quarterly to determine whether the underlying assets are sufficient to cover the total outstanding nominal value of the covered bonds. Stress testing must cover all risks that may significantly affect the covered bonds' risk profile.

VI. TRANSPARENCY

The Law obligates the issuer to disclose information to the investors and creditors, and to the Commission. Additionally, the Commission ensures availability of general information about issuers and cover bond programmes on its webpage.

Under the Law, the issuer must inform the investors on quarterly basis about the results of a covered bond programme, so that investors can assess its profile and risks and evaluate their own investment. The information for investors must be published on the issuer's webpage, and it must be made available for at least five years. The following information must be published: the value of the cover pool and outstanding covered bonds; the

list of international securities identification numbers (ISIN) of all the covered bonds; the geographical division of cover assets; detailed information about market risk; levels of coverage and overcollateralisation; share of loans in case of delayed payments as per Article 178 of CRR, and the amount of liquidity reserves.

Additionally, the covered bond company (the SPV) must publish the annual report together with a sworn auditor's report on its website or indicate another appropriate medium where this information is made public.

The Commission in supervising the implementation of the covered bond programme is entitled to request the issuer, the covered bond company (the SPV) and the cover pool monitor to disclose information and other related documents for public.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The Law provides an obligation for the issuer to appoint a cover pool monitor that ensures constant monitoring of the cover pool. A cover pool monitor may be a sworn auditor or a sworn auditor company. Additionally, the cover pool monitor must be independent from the issuer and issuer's internal auditor. The person who was auditor of the issuer during last two years cannot take a position of cover pool monitor. The cover pool monitor's duties include, but are not limited to:

- (1) the examination of the compliance with the regulatory requirements of cover assets management agreement and the cover assets structure at least once a year;
- (2) the verification of the accuracy of the entries in the cover asset records; and
- (3) the verification on whether the covered bond company (the SPV) and the issuer complies with the legal requirements and duly perform their obligations regarding cover asset management agreement, stress testing, information provision to investors and cooperation with the Commission.

The cover pool monitor performs on-going supervision of the cover pool. The Law does not prescribe the regularity of inspections. The frequency of inspections must be determined for each particular situation. By way of example, the explanation to the Law indicates that the accuracy of the underlying asset records plays an important role in protecting the interests of investors and presumably it would not be appropriate to check this aspect only once a year. The Law allows the issuer, the cover pool monitor and the Commission to determine the frequency of monitoring of each of the aspects.

The Law obligates the cover pool monitor to provide the Commission with an annual report on the compliance of the covered bond programme with the requirements of the Law which have been described above. The cover pool monitor cooperates with the Commission. The cover pool monitor must immediately inform the Commission, as well as the covered bond company (the SPV) and the trustee (if such is appointed), of any violations identified.

The cover pool monitor is liable to investors for losses incurred by them due to gross negligence or malicious intent of the cover pool monitor. The liability period for the claims of damages is three years.

The Commission performs public supervisory functions of the covered bond programmes, including, the emission of covered bonds. The Commission has the duty and the powers to take necessary actions to prevent or remedy issues in the operation of the issuer, the transferor and the covered bonds company (the SPV) which may threaten the stability of the financial system or create significant losses for the economy. Including, the Commission may adopt the necessary sanctions in respect of the entities or natural persons responsible for non-compliance, which include fines to up to 10% of the annual revenue of the entity, revocation of the licence for cover bonds programme, temporal prohibition for the natural person liable for the non-compliance to fulfil his duties, etc

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

The Law contains the principle that the claims of investors and creditors of covered bonds against the issuer and the covered bond company rank *pari passu*, i.e. the claims of the investors do not have any preference over the claims of the creditors. However, in respect of other creditors, cover assets may not be subject to enforce-

ment in respect of the issuer, the transferor of claims included in the covered bond portfolio, the covered bond company (the SPV) or the manager of the cover pool. This rule does not restrict the possibility to enforce the claims against the debtor or the security provider of the assets underlying the covered bonds. Enforcement may be taken in respect of such cover assets that remain after the fulfilment of the claims of the investors and creditors of the covered bonds.

According to the Law, in case of the insolvency proceedings of the issuer, the amount of investors' and creditors' claims against the covered bond company is limited by the cover assets owned by the covered bond company. If the cover assets cannot cover the claims of all investors and creditors, these claims are satisfied according to principle of proportionality.

In case insolvency proceedings of an issuer have been declared as set by the Insolvency Law, the Commission appoints a special administrator. The special administrator acts in the interests of all investors and creditors of the covered bonds, with the aim of achieving the proper performance of all covered bond claims from the coverage and the income generated by the covered bonds.

The special administrator upon appointment or at the request of the Commission must immediately evaluate the cover assets. The special administrator also approves and submits to the issuer's insolvency administrator a list of investors and creditors of the covered bonds. The issuer's insolvency proceedings cannot be completed until the covered bond company is sold to another issuer, or the covered bond claims are fully satisfied, or the sale of all covered assets is completed.

IX. COMPLIANCE WITH EUROPEAN LEGISLATION

The Law is in compliance with the following European legislation that sets out requirements regarding covered bonds:

- (1) the Covered Bonds Directive (CBD) – the Directive No 2019/2162 of the European Parliament and of the Council of 27 November 2019 on the issue of covered bonds and covered bond public supervision and amending Directives 2009/65/EC and 2014/59/EU;
- (2) the CRR¹ – the 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.

X. PENDING AMENDMENTS TO THE LAW

On 23 March 2023 amendments to the Law were submitted to the committee which accepted these amendments and referred to the Budget and Finance Commission for consideration in the first reading. The amendments relate to the Bank of Latvia overtaking the financial services' supervision from FCMC and thus update references from the FCMC to Bank of Latvia. Certain regulations based on the Law will also be updated in this respect. Also, the amendments foresee various, mostly technical and minor changes to the Latvian covered bonds regulation. As of this date, the amendments are not yet passed.²

¹ Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): <https://hypo.org/ecbc/covered-bonds/>.

² Amendments to the Covered Bonds Law. (In Latvian – Grozījumi Segto obligāciju likumā). Please click on the following link for further information: <https://titania.saeima.lv/LIVS14/SaeimaLIVS14.nsf/0/CB392122D1217F82C2258979002606E9?OpenDocument>.

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:

