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RESEARCH ARTICLE

DRAFT AMENDMENT TO THE POLISH ACT ON COVERED BONDS AND MORTGAGE BANKS WITH EMPHASIS ON THE POLISH STATE-OWNED DEVELOPMENT BANK ("THE BANK GOSPODARSTWA KRAJOWEGO"). AMENDMENTS PROPOSED BY THE AUTHOR

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ABSTRACT

The purpose of this paper is to assess current and suggested provisions of the Act on Covered Bonds and Mortgage Banks, in particular with respect to the Bank Gospodarstwa Krajowego. Having the purpose of the Bank Gospodarstwa Krajowego in mind, specified in Article 4 of the Act on the Bank Gospodarstwa Krajowego, it would seem appropriate to reinforce the rights of the Bank Gospodarstwa Krajowego with respect to issuing covered bonds and certain tax exemptions.

Key words:

covered bond, mortgage bank,
the Bank Gospodarstwa
Krajowego, withholding tax

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INTRODUCTION

The purpose of this paper is to assess current and proposed provisions of the Act on Covered Bonds and Mortgage Banks, in particular with respect to the Bank Gospodarstwa Krajowego. The Author intends to conduct an economic analysis of the legal framework for the issuance of covered bonds in order to find and propose an optimal solution, which would improve the condition of at least one subject without hindering the condition of other subjects (Pareto). The Author shall attempt to prepare proposed amendments enabling the application of solutions, which are more beneficial than those proposed by the government.

Suggested Amendments To The Act Of 29 August 1997 On Covered Bonds And Mortgage Banks

The Act on Covered Bonds and Mortgage Banks, adopted in 1997, did not contribute to the development of these long-term debt securities. Presently, the ratio of covered bonds to granted residential mortgage loans in the Polish banking sector is 0.7%, whereas in the Czech Republic this ratio amounts to 42%. Furthermore, it must be noted that the so-called CRDIV/CRR

package¹ covers the introduction of changes to long-term liquidity standards. The obligation to maintain a level of stable funding will be substantially increased with, among other things, long-term debt securities; lack of development thereof may directly contribute to the necessity of reducing the volume of lending, which may negatively impact the real economy (grounds for the draft amendment to the Act on Covered Bonds and Mortgage Banks, 2015)

On 9th June 2015, the Council of Ministers adopted the draft Act amending the Act of 29th August 1997 on Covered Bonds and Mortgage Banks and Certain Other Acts.

The draft Act covers amendments improving the security of covered bond creditors, which shall increase the rating of these securities and decrease the banks' cost of funding whilst removing current barriers related to the attractiveness of covered bonds for their investors. The purpose of this

¹ The Directive 2013/36/EU of the European parliament and of the Council of 26th June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, OJ EU L 176 of 27th June 2013, p.338, as amended, and the Regulation (EU) No. 648/2012 of the European Parliament and of the Council of 26th June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012, OJ EU L 176 of 27th June 2013, p. 1.

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regulation is to improve the attractiveness of Polish covered bonds.

The draft amendment aims to develop the market for covered bonds issued by mortgage banks, which are long-term debt securities with a high level of security and a low investment risk. Introduction of solutions for the development of long-term securities, such as covered bonds, should improve the security of the banking sector by limiting funding of long-term loans with short-term deposits. The proposed amendments aim to provide a high level of security for purchasers of covered bonds in case of insolvency of mortgage banks and to reduce the cost of funding bank businesses while removing current barriers related to the attractiveness of covered bonds for potential investors. The proposed adjustment of covered bonds issued in Poland to European standards shall enable Polish covered bonds to compete with similar instruments issued in other European Union countries.

Table 1 Activities of the Polish mortgage banks

Item	Status as at 31.12.2014
Covered bonds	
New issues of covered bonds in 2014 in PLN	1,150,495,650
Outstanding covered bonds in PLN	4,129,168,715
of which mortgage covered bonds in PLN	3,779,168,715
of which public covered bonds in PLN	350,000,000
Total assets	8,004,108,009
Receivables from the non-financial and budget sector in PLN	7,160,636,740
of which:	
residential mortgage loans	1,832,275,408
of which:	
for businesses	463,675,655
of which in foreign currency	0
for individuals	1,368,599,753
of which in foreign currency	247,570,795
commercial mortgage loans	4,327,956,816
of which in foreign currency	3,128,671,400
Granted residential mortgage loans	
Number of loans	3,782
Value of loans in PLN	1,625,664,882
Granted commercial mortgage loans	
Number of loans	73
Value of loans in PLN	1,314,761,083

Source: The Polish Mortgage Credit Foundation, Warsaw, Poland.

The fundamental amendment proposals included in the draft Act are (grounds for the draft amendment to the Act on Covered Bonds and Mortgage Banks, 2015):

1. Enable banks to take advantage of refinancing of loans on a larger scale by issuing covered bonds. It would be achieved by providing the means to increase the security of covered bonds, transparency of the issuer bankruptcy process and the attractiveness of covered bonds for potential investors.
2. Increase the statutory protection of rights of covered bond creditors (purchasers) by introducing detailed provisions regulating the process of satisfaction of creditors in case of insolvency of the issuer, and by outlining the mortgage bank bankruptcy process.
3. Introduce solutions for improving the security of mortgage bank activities (statutory overcollateralization requirement, liquidity buffer). Mortgage banks shall be obligated to maintain the

statutory overcollateralization requirement for covered bonds in the amount of at least 10% of the issuance value and the liquidity buffer to cover the payment of interest with respect of covered bonds for 6 subsequent months.

4. Increase the limit to enable refinancing, using assets from issuing covered bonds, of residential mortgage loans – from its current rate of 60%, to 80% of the mortgage lending value of the real property.

However, an amendment to the tax acts, i.e. the Act of 26th July 1991 on Personal Income Tax and the Act of 15th February 1992 on Corporate Income Tax, was proposed, as a part of the amendment package, in order to extend the exemption, with respect to flat-rate income taxation of natural and legal entities, from interest or discount on covered bonds. In both cases such exemption would cover non-residents, both from domestic and foreign investments.

The project also proposes an amendment to the Act of 28th February 2003 on Bankruptcy and Rehabilitation Law. An amendment was proposed to Article 429, Item 1a thereof, according to which, in case of insolvency of a mortgage bank, the general principle of Article 429, Item 1 of the Act on Bankruptcy and Rehabilitation Law, which gives priority to the arrangement bankruptcy of such bank, shall not apply. The arrangement bankruptcy should not apply to the bankruptcy estate, because it would not guarantee security of the investors' interests in covered bonds. It was also proposed, by introducing Articles 445a and 445b, to establish a specific meeting of covered bond creditors, reflecting the meeting of creditors. Such meeting would be convened upon a request of covered bond creditors representing at least 10% of receivables from the nominal value of covered bonds remaining in circulation. Convening a meeting of covered bond creditors would be obligatory in case an approval is necessary to dispose of the securities from the securities register in full by the trustee, provided that proceeds from sales do not satisfy the costs of proceedings and covered bond creditors in their entirety or in part, in the event of planning sales at less than fair value.

The amendment to Article 446 of the aforementioned Act would introduce the principle of postponing the deadline for redemption of covered bonds, which would enable the trustee to settle the matters related to assets of the insolvent bank, including conducting assessments in order to determine the further conduct of proceedings. The proposition of a new Article 446a regulates the issue of balance-sheet and liquidity tests, the results of which would determine the further conduct of proceedings. Conducting such tests would fall under the jurisdiction of the trustee, and their results would be submitted to the supervising body as well as published. In case of positive results of both aforementioned tests, covered bond receivables would be satisfied in accordance with the maturity date postponed for 12 months. At the same time, the creditors would be entitled to obligate the trustee to act in order to liquidate the bankruptcy estate. In case of a negative result of the liquidity test and a positive result of the balance-sheet test (unless otherwise agreed by the creditors), a so-called *pass-through* structure would be introduced, which would consist of

deferring all capital payments (including covered bonds, the liabilities of which would become payable before the bankruptcy declaration) to the last possible maturity date for assets entered into the register of securities plus three years – in case it is necessary to sell bankruptcy estate assets entered into the register of securities, in particular due to court and enforcement proceedings. Moreover, the aforementioned *pass-through* procedure would be applicable in case of a negative result of both tests.

Amendments Suggested By The Author

With regard to the foregoing project, circumstances have arisen for proposing solutions beneficial from the point of view of interests of the national economy – by taking advantage of Bank Gospodarstwa Krajowego.

Besides mortgage banks (three to date, i.e. Pekao Bank Hipoteczny S.A., PKO Bank Hipoteczny S.A., mBank Hipoteczny S.A.), since 23rd February 2011, on the basis of Article 6a introduced into the Act on the Bank Gospodarstwa Krajowego, Bank Gospodarstwa Krajowego may issue covered bonds as well, in particular in order to implement Government programmes mentioned in Article 5, paragraph 1, item 7, i.e. supporting the development of residential constructions, in particular constructions of residential units for rent, in accordance with separate principles or as a part of implementing government programmes.

A part of the Bank Gospodarstwa Krajowego's business is dedicated to granting loans for the financing of real property. Enabling Bank Gospodarstwa Krajowego to issue covered bonds creates a possibility of applying refinancing. Taking into account the security of the Bank Gospodarstwa Krajowego's operations, it is possible to provide long-term security for covered bonds, as primary refinancing instruments for the business area related to the financing of real property, issued by the Bank Gospodarstwa Krajowego.

Reflecting the pre-war tradition of the Bank Gospodarstwa Krajowego, it must be noted that one of the primary objectives of the Bank, in accordance with Article 5 of the Ordinance of the President of the Republic of Poland of 30th May 1924 on the Merger of State Credit Institutions into the Bank Gospodarstwa Krajowego, was to grant long-term loans by issuing mortgage-secured covered bonds. In accordance with Article 8 of the Ordinance of the President of the Republic of Poland, the Bank was entitled to issue covered bonds with values in Polish currency (in gold) or foreign currencies. The sum of covered bonds in circulation could not exceed the overall sum of concurrent mortgage receivables; furthermore, under Article 6 of the Ordinance of the President of the Republic of Poland, covered bonds issued by Bank were covered by statutory guarantees of the Treasury – with no upper limit for granted guarantees. The Bank charter determined the fraction of net profit allocated to the reserve fund for covered bonds.

The particular security of the Bank Gospodarstwa Krajowego is a result of legal acts, which establish this entity. Article 3, Item 3 of the Act of 14th March 2003 on the Bank Gospodarstwa

Krajowego states that the Minister responsible for public finances provides Bank's internal funds at a level, which guarantees the performance of Bank Gospodarstwa Krajowego's tasks and maintains the cash flow liquidity standards, which is specified in provisions of the Act of 29th August 1997 on the Banking Law. It must be noted that the aforementioned obligation applies to all of Bank's businesses, not only to the part ordered by the Government. In order to satisfy the aforementioned obligation, the Minister responsible for financial institutions provides an appropriate set of tools specified in Article 3a (State Treasury liquidity guarantees), Article 5a (capital injection using State Treasury bonds) and Article 5c (enabling the granting of a subordinated loan using state budget funds) of the Act on the Bank Gospodarstwa Krajowego. Article 3, item 4 of the Act on Bank Gospodarstwa Krajowego directly states that in case of Bank's liquidation, its obligations are transferred to the State Treasury (Skuzza, 2015). The Bank Gospodarstwa Krajowego is an entity without bankruptcy capacity. In accordance with Article 5, point 4 of the Act of 28th February 2003 on Bankruptcy and Reconstruction Law, no bankruptcy can be declared for institutions and legal entities established under an Act, unless such Act provides otherwise. Furthermore, no bankruptcy can be declared for entities established by performing statutory obligations. Article 3, Item 2 of the Act on the Bank Gospodarstwa Krajowego, in its current meaning, confirms that the Bank Gospodarstwa Krajowego has no bankruptcy capacity, by stating that Article 6, point 4 of the Act on Bankruptcy and Reconstruction Law is applicable to the Bank Gospodarstwa Krajowego [Skuzza, 2015]. The Treasury, local government units, public independent health care institutions, institutions and legal entities established under an Act, natural persons managing farming enterprises, and education facilities cannot declare bankruptcy. The Bank Gospodarstwa Krajowego belongs (*expressis verbis*) to the category of "institutions and legal entities established under an Act". Besides the Bank Gospodarstwa Krajowego, other examples of such institutions and legal entities include the Polish Banking Guarantee Funds and the Polish State-owned Enterprises "National Airports" [Heropolita ska et al., 2014; Skuzza, 2015]. In the opinion of the Author, suggesting amendments with respect to the base for issuing public covered bonds would be reasonable. Presently, in accordance with Article 3, Item 2 of the Act on Covered Bonds and Mortgage Banks, bases for issuing public covered bonds include:

1. parts of loans along with payable interest secured by a guarantee or a surety of the National Bank of Poland, the European Central Bank, Governments or central banks of European Union member countries, Organizations for Economic Co-operation and Development, excluding countries, which are restructuring or have restructured its external debt within the last 5 years, and by a guarantee or a surety of the State Treasury in accordance with provisions of separate Acts; or
2. loans granted to entities listed in point 1; or
3. parts of loans along with payable interest secured by a guarantee or a surety of local self-government units and loans granted to local government units.

In the opinion of the Author, provisions of the amendment to the Act should include the possibility of extending the base for issuing public covered bonds with guarantees and sureties as well as any and all receivables of the Bank Gospodarstwa Krajowego or entities, the obligations of which are covered by the loan protection of the State Treasury, within the meaning of Articles 213-215 of the Regulation No. 575/2013 on prudential requirements for credit institutions and investment firms (“CRR”). The argument for adopting such a solution is *de facto* identical profile of risk for mortgage banks.

Moreover, a proposal for extending the base for issuing public covered bonds should be considered. The object of the proposal is to introduce debt securities issued by entities listed in Article 3, Item 2, item 1 of the Act on Covered Bonds and Mortgage Banks, as well as debt securities of Bank, as the base for issuing public covered bonds. The aforementioned concept appears to be reasonable from the point of view of the nature of receivables characterized by the same risk profile. It must be also noted that the State Treasury funds lending requirements almost exclusively using bonds, not domestic market loans. With the principle of equal treatment of covered bond issuers in mind, mortgage banks should be also able to allocate available monetary assets to covered bonds issued by the Bank Gospodarstwa Krajowego.

It must be also noted that the suggested amendment to Act would also amend provisions of the Act of 26th July 1991 on Personal Income Tax and the Act of 15th February 1992 on Corporate Income Tax, with respect to the application of *withholding tax* for revenues generated by non-residents from interest or discount on covered bonds. It also appears reasonable to introduce provisions with respect to a statutory objective exemption from revenues generated by non-residents from interest or discount on covered bonds issued on foreign markets by the Bank Gospodarstwa Krajowego as well as from revenues from sales of such securities. Presently, the aforementioned analogous waiver exists at the regulatory level. In accordance with the Ordinance of the Polish Minister of Finance of 4th November 2011 on Waiver of Income Tax Collection from Certain Types of Revenues (Income) for Taxpayers of Personal Income Tax and of Corporate Income Tax, the following are exempt from tax: revenues (income) generated by taxpayers, who are natural persons without place of residence in the Republic of Poland, from interest or discount on securities issued on foreign markets by Bank as well as from revenues from sales of such securities, and revenues (income) generated by taxpayers, who are legal entities, business units without legal personality and companies without legal personality, without a registered office or administrative units in the Republic of Poland – provided that, in accordance with provisions of law of the country, in which their registered office or administrative unit is established, they are treated as legal entities and are subject to total income taxation in this country, regardless of where such income is generated, from interest or discount on securities issued on foreign markets by Bank as well as from revenues from sales of such securities; this waiver was applicable to revenues (income) generated by 31st December 2023, however, the Ordinance of the Minister of Finance of 5th September 2014

amending the Ordinance on Waiver of Income Tax Collection from Certain Types of Revenues (Income) for Taxpayers of Personal Income Tax and of Corporate Income Tax extends this deadline to 31st December 2030 (Opinion of the Polish Government Legislation Centre, 2014; Skuza, 2015).

In accordance with the opinion of the Polish Government Legislation Centre stated in the legislation process for the aforementioned legal solution, *withholding tax* exemption for Bank (with respect to the collection of tax for Bank’s securities issued on foreign markets) should be implemented by way of an Act, not in the form of an ordinance.

It must be stressed that the Polish Ministry of Finance, in the letter dated on 25th May 2015, No. DD5.8020.2.2015.AWE, rendered the qualified consent to the introduction of amendments with respect to *withholding tax*, at the same time indicating the necessity of providing the purpose for issuing such securities by the Bank. Nevertheless, in the opinion of the Author, it must be noted that, in accordance with Article 4 of the Act of 14th March 2003 on the Bank Gospodarstwa Krajowego, the primary purpose of the Bank’s business constitutes a sufficient satisfaction of the requirement (purpose) indicated by the Polish Ministry of Finance.

The Author suggests his own propositions of the amendment to the Act below:

1. the following items in the Act of 29th August 1997 on Covered Bonds and Mortgage Banks shall read:
2. Article 3, item 2, point 1 shall read as follows:
3. *Public covered bonds are registered or bearer securities, which are issued on the basis of mortgage bank receivables from:*
 - a. *parts of loans along with payable interest secured by a guarantee or a surety of the National Bank of Poland, European Central Bank, Governments or central banks of European Union member countries, Organizations for Economic Co-operation and Development, excluding countries, which are restructuring or have restructured its external debt within the last 5 years, and by a guarantee or a surety of the State Treasury in accordance with provisions of separate Acts, or of Bank Gospodarstwa Krajowego or entities, the obligations or businesses of which are secured by obligations of the State Treasury, granted in accordance with provisions of separate Acts, an which satisfy the requirements of lending protection in the meaning of Articles 213-215 of the Regulation No. 575/2013; or,*
4. to Article 3, item 2, the following item 4 shall be introduced and read as follows:
5. *Public covered bonds are registered or bearer securities, which are issued on the basis of mortgage bank receivables from:(...)*
6. *debt securities issued by entities listed in points 1 and 3,*
7. Article 16, item 1, point 5 shall read as follows:
8. *Article 16. 1. Available monetary assets may be allocated by mortgage banks to:(...)*
9. *purchases of covered bonds issued by other mortgage banks and the Bank Gospodarstwa Krajowego.*

10. the following amendments shall be introduced in the Act of 15th February 1992 on Corporate Income Tax:
11. *Article 17. 1. The following are exempt from tax:(...)*
12. *interest or discount on securities issued on foreign markets by the Bank Gospodarstwa Krajowego in order to finance businesses for the satisfaction of the purpose mentioned in Article 4 of the Act on the Bank Gospodarstwa Krajowego (Journal of Laws of 2014, item 510, as amended) as well as revenues from sales of such securities generated by taxpayers specified in Article 3, item 2 (non-residents taxpayers);”*
13. the following amendments shall be introduced in the Act of 26th July 1991 on Personal Income Tax:
14. *„Article 21. 1. The following are exempt from income tax:(...)*
15. *130b) interest or discount on securities issued on foreign markets by the Bank Gospodarstwa Krajowego in order to finance activities for the satisfaction of the purpose mentioned in Article 4 of the Act on the Bank Gospodarstwa Krajowego (Journal of Laws of 2014, item 510, as amended) as well as revenues from sales of such securities generated by taxpayers specified in Article 3, item 2a (non-residents taxpayers);”.*

Summary

In the opinion of the Author, the homogeneous risk profile for entities or financial instruments should be a sufficient reason to assign identical rights with respect to the issuance of public covered bonds. Furthermore, it must be stressed that risk weight of banking regulations for entities having guarantees of the Treasury is lower (0%) than for local government units (20%). Having the purpose of the Bank Gospodarstwa Krajowego in mind, specified in Article 4 of the Act on the Bank Gospodarstwa Krajowego, it would seem appropriate to reinforce the rights of the Bank Gospodarstwa Krajowego with respect to issuing covered bonds and certain tax exemptions.

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