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Covered Bonds: The Next Popular Turkish Security

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Mortgage Covered Bonds ("MCBs") are expected to become a major funding tool for Turkish banks over the next decade. This is driven by a growing real estate market (and the relatively infant-stage mortgage market) on the demand side, and the Turkish banking sector's chronic maturity mismatch problem on the supply side.[1]

While the legal framework for MCBs has been available under Turkish capital markets rules since 2007, recent rule amendments were made to create a better-functioning market for MCBs. In this article, we examine the balance that these amendments strike between investor protection on one hand, and funding flexibility for issuers on the other hand.[2]

In general, MCBs are debt instruments secured by a pool of mortgage loans, which loans are in turn secured by underlying real estate collateral. In the event of a default on the MCBs, the investors have a preferential claim on the mortgage loan collateral. The scope of such claim is defined by various protective features available under the applicable legal framework. They include issuer and asset eligibility, overcollateralization requirements, bankruptcy remoteness, additional credit enhancement mechanisms, monitoring of cover assets and regulatory supervision.

Issuer and Asset Eligibility

In Turkey, MCBs can only be issued by eligible issuers that are regulated entities. These include banks and other financing institutions, mortgage financing corporations, financial lease companies and real estate investment trusts. MCB holders have recourse against both the issuer's balance sheet as well as the asset pool, in keeping with the so-called "dual-recourse" nature of covered bonds in general.

The aggregate principal amount of the MCBs may not exceed 10% of the total assets of the issuer, or 20% if the issuer has a long-term investment grade credit rating in one of the three highest rating categories of the relevant credit rating agency.

The assets in the cover pool must consist of (i) receivables that are secured by a mortgage (where the receivable arises from a housing loan, a financial leasing arrangement, or a commercial credit), (ii) installment receivables from sales made by Turkey's state housing agency, (iii) cash and cash equivalents that are defined in the rules, (iv) rights and obligations arising from interest rate or foreign exchange hedging arrangements in respect of the MCBs (subject to certain conditions such as the hedge counterparty having a long-term investment grade credit rating), or (v) any other assets that may be approved by the Capital Markets Board (the "Board"). The recent rule changes provide some flexibility in respect of the first category above, by permitting receivables arising from housing loans that are not secured by a mortgage to be included in the cover pool, so long as they are secured by other collateral to be approved by the Board.

A few of these asset categories were added by the revised rules, including receivables from financial leasing arrangements and commercial credits, and all of the rights and obligations related to hedge instruments (as opposed to the 15% limit which used to apply under the old rules). While these revisions expand the pool size generally, they also ensure that the hedge counterparties have the benefit of the bankruptcy protection (discussed below) afforded to the cover assets.

In addition to these eligibility criteria, the underlying real estate must be located in Turkey and must have been valued by an appraisal firm that is approved by the Board or the Turkish banking regulator. The old rules required that the real estate have an "occupancy permit." However, in response to comments from the market that such requirement would significantly diminish the size of eligible assets and thus hinder the MCB market, this requirement was omitted under the new rules.[3]

1 According to recent statistics of the Turkish banking regulator, a majority of Turkish banks' assets (consisting mainly of loans) have a maturity longer than one year, while a majority of their liabilities (consisting mainly of deposits) have a maturity of three months or less.

2 While the Turkish rules provide for various types of covered bonds, this article focuses on mortgage covered bonds only.

3 According to an article published in Habitat International, an estimated 81% of buildings in Istanbul do not have an occupancy permit.

Another flexibility afforded by the new rules is that the issuer may add to and remove from the ineligible assets pool, but only to the extent that there is no violation of cover "matching" requirements (discussed below) and the issuer continues to fulfill its payment obligations under the MCBs and related derivative arrangements.

The issuer may use the cash proceeds generated from the cover assets so long as the issuer continues to fulfill its payment obligations under the covered bonds and derivatives. Under the old rules, such cash proceeds had to be retained as part of the cover asset pool, essentially using the cover pool as a debt service account. Similar to the other elements discussed above, the revised rules provide flexibility to the issuers so long as they are in compliance with the terms of the MCBs.

Overcollateralization Requirements

The issuer must ensure that three types of so-called "matching" requirements are met in respect of the MCB obligations and the cover assets. The issuer must confirm these requirements every time there is a change in the cover register (discussed in more detail below) and in any event at least once a month.

- **Net present value test** – The net present value of the underlying assets must be at least 2% higher than the net present value of the MCB obligations, to be calculated according to Turkish Accounting Standards or other standards to be specified by the Board. The 2% mandatory amount of excess assets must be in the form of cash or cash equivalents specified in the rules. The issuer must perform monthly stress tests on the net present value that account for sensitivity to interest rate and foreign exchange fluctuations.

- **Nominal value test** – The aggregate principal amount of the housing loans may not be less than the principal amount of the MCBs (not taking into account the value of derivatives);

- **Cash flow test** – The aggregate amount of proceeds (including interest and other income) to be generated from the housing loans over the next year may not be less than the same payments payable under the MCB over the same period.

In all three tests above, any amount of receivables exceeding 75% of the value of the underlying real estate must be disregarded which acts as an additional protection.

Until the MCBs are repaid or redeemed, the cover assets cannot be disposed of for any purpose (other than securing payment on the MCBs as discussed below), pledged or otherwise designated as collateral, attached by third parties (including for collection public receivables such as taxes), included in the bankruptcy estate of the issuer, or be subject to any injunctive relief by courts.

Bankruptcy Remoteness

Until the MCBs are repaid or redeemed, the cover assets cannot be disposed of for any purpose (other than securing payment on the MCBs as discussed below), pledged or otherwise designated as collateral, attached by third parties (including for collection public receivables such as taxes), included in the bankruptcy estate of the issuer, or be subject to any injunctive relief by courts. This protection applies even if the management or the supervision of the issuer is transferred to public institutions.

In the event the issuer is bankrupt, its operation license is cancelled, or its management is transferred to public institutions, the Board may appoint an administrator to manage the cover assets. The administrator is responsible for (i) actively managing the cover assets collecting any income received from the cover assets in a separate account of the issuer, and paying such income to the MCB holders (and the derivative counterparties) as a priority, or (ii) transferring the cover assets and MCB liabilities partially or fully to another eligible institution with the approval of the Board.

In either case, if the income from the cover assets is ultimately insufficient to pay the MCB obligations, the administrator is not responsible for paying such shortfall. In that event, the MCB holders would have recourse to the issuer's other assets to the extent of such shortfall, pari passu with the unsecured creditors of the issuer.

Additional Credit Enhancement

The Board also has the power to require additional credit enhancement features or protective mechanisms for particular MCB issues. These include requiring insurance or guarantees from a Turkish bank or other third party for the MCBs, making the optional appointment of a servicer or a cash manager (which is discussed below) obligatory, requiring the cover assets to be held in the custody of a bank or other financing institution, or restricting the offering of MCBs to qualified investors only.

Despite the time, effort and expense involved in issuing MCBs, market players are generally optimistic that the new Board regulations will provide a good platform for achieving a well-functioning public market for MCBs in Turkey.

Monitoring of Cover Assets

Issuers must keep a "cover register" that identifies the cover assets. In addition, prior to issuing MCBs, issuers must engage a "cover monitor" to supervise the cover assets. The cover monitor cannot be the issuer's outside auditor. The Board may replace a cover monitor that is negligent or in breach of its duties. The cover monitor's duties include the following:

- monitoring the formation of the cover pool with eligible assets;
- monitoring the cover pool's compliance with the cover matching principles and the accuracy of the stress tests discussed above;
- examining the accuracy of any cover register that is kept in electronic form, and providing reports to the issuer and the Board;
- examining the accuracy of cover register entries regarding addition, removal or replacement of cover assets, and preparing periodic reports thereon; and
- in the event of a cover matching violation or a default by the issuer of its general obligations, examining whether the measures under the rules are followed, and preparing periodic reports thereon.

In addition to the cover monitor, the issuer has the option to appoint a servicer for administration of the cover pool, and a cash manager for collecting sums under the cover pool assets and making payments to MCB holders. The Board may make such appointment mandatory, and may supervise the records of such servicer or manager.

Transparency

In order to ensure transparency to MCB investors, issuers must disclose the following information publicly on the issuer's website and on specific disclosure platforms (depending on whether the MCBs are publicly issued or privately placed):

- the various compliance reports prepared by the cover monitor;
- quarterly reports by the issuer indicating income received from the cover assets, payments made to the MCB holders, and other material information required on Form-5 attached to the rules; and
- any default on the issuer's payment obligations under the MCBs.

In addition, if the issuer is a reporting company, it must publicly disclose any information that may affect the value and price of capital market instruments or the investment decision of investors.

Issuance Process

MCB issuances are subject to Board approval. In registered offerings, the issuer must submit to the Board a draft of the offering circular to be provided to prospective investors, underwriting agreement, agreements with third parties such as the cover monitor or servicer, hedge agreements, and various other documents that are listed in the rules. In private placements, the issuer must submit to the Board a draft of the issuance certificate to be provided to prospective investors, agreements with the cover monitor and various other documents that are listed in the rules. In both cases, the cover register must be prepared prior to the MCB issuance.

The minimum subscription amount for MCBs is the equivalent of 100,000 Turkish liras (approximately $40,000 at present exchange rates), unless the issue is outside of Turkey or by way of a private placement. MCBs can also be denominated in foreign currency. MCBs issued in both domestic and international offerings must be in dematerialized form and registered with the Turkish central registration agency.

Conclusion

The number of MCB issuances in Turkey is still very few. However, various issuers and arrangers anticipate activity in this area to increase over the next few years, and eventually hope to see a well-functioning public market for MCBs in Turkey. Despite the time, effort and expense involved in issuing MCBs, market players are generally optimistic that the new Board regulations will provide a good platform for achieving this goal. In addition, external factors such as the European Central Bank's Euro 1 trillion covered bond purchase program are viewed as promising to have a positive spillover effect in Turkey, even though Turkey is outside the Eurozone and not a beneficiary of the purchase program. ■