

### **3.10 FINLAND**

By Timo Ruotsalainen, Aktia Bank plc and Bernd Volk, Deutsche Bank

#### **I. FRAMEWORK**

There are currently seven issuers of Finnish covered bonds. In Finland, the legal basis for covered bond issuance is the Act on Mortgage Credit Bank Operations (HE 42/2010). The new legal framework replaced the old Act on Mortgage Credit Bank (1999) and entered into force on 1 August 2010. The new law overruled the special banking principle and gathered all Mortgage Credit Bank related legislation under the same act. Besides, other technical changes, e.g. mixed pools, have been allowed.

The provisions of the new legal framework do not apply to covered bonds issued or derivatives contracts registered before the entering into force of the new act. No counterparty restrictions apply and derivative counterparties are typically internal.

#### **II. STRUCTURE OF THE ISSUER**

The issuer of Finnish covered bonds can be a universal bank or a specialist mortgage bank. Generally, entities that can issue covered bonds are credit institutions authorised to engage in mortgage credit bank operations. The issuer of Finnish Covered Bonds can still be a specialised bank, but deposit banks or credit entities are entitled to apply for a licence to issue covered bonds. The existing specialised banks tend to stay in business in the way they have been operating since being established. Unless it is a mortgage credit bank, the issuer must obtain a license to engage in mortgage credit bank operations (i.e., issue covered bonds).

The Finnish covered bond law stipulates certain requirements to receive a covered bond issuance license. The covered bond issuer should provide a business plan, show financial stability, expertise in mortgage credit operations, risk management and practices concerning valuation of collateral. Interestingly, the requirements to receive a Finnish covered bond license seem very similar to the requirements to receive a German Pfandbrief license.

The issuer holds the cover assets on the balance sheet. A subsequent transfer of the cover assets to another legal entity is not taking place. A direct legal link between single cover asset and the covered bonds issued does not exist. All obligations from Finnish Covered Bonds are direct and unconditional obligations of the issuing bank as a whole. In the case of insolvency, the cover pool is segregated by law from the general insolvency estate and is reserved only for the claims of the holders of Finnish Covered Bonds.

Under the previous legal framework, only bonds covered by mortgages were issued by Finnish mortgage banks. A separate cover pool was to be established if these banks were to start the issuance of public-sector backed Finnish Covered Bonds. Under the new law, mixed pools comprising mortgage loans as well as eligible public sector assets are allowed.

#### **III. COVER ASSETS**

Finnish covered bonds have a cover pool register that includes all cover pool assets, covered bonds and derivatives. Eligible assets for Finnish covered bonds are residential mortgage loans (including shares in Finnish housing companies), commercial mortgage loans, public sector loans and substitution assets. At least 90% of the cover pool loans must consist of residential mortgage loans, public-sector loans or substitution assets. Cover pool assets can be within European Economic Area countries.

Enforcement of non-Finnish cover pool assets would usually be determined by the laws of the jurisdiction in which the assets. Due to European law, inside the EU, enforcement is safeguarded anyway. However, Finnish issuers have so far only Finnish assets in the covered bond pools.

Derivatives may also be registered in the cover pool. The geographical scope of cover assets is restricted to the European Economic Area (EEA). Residential mortgage loans, shares in housing companies as well as commercial mortgage loans up to 10% of the total pool are eligible as cover assets.

Public sector loans in accordance with Article 129(1) CRR are also eligible.

Specialised mortgage credit bank can grant an intermediate credit to a deposit bank or a credit entity. This intermediate credit must be covered with eligible cover assets as stated above. These assets must also be recorded into the cover register.

Up to 20% of the mortgage cover pool is allowed to consist of substitute cover assets; bonds and other debt obligations issued by the State, a municipality or another public-sector organisation or another credit institution than one belonging to the same consolidation group as the issuer; a guarantee as for own debt granted by a public-sector organisation or credit institution referred above; a credit insurance given by an insurance company other than one belonging to the same group, referred to in the Act on Supervision of Finance and Insurance Groups; cash assets of the issuer deposited in the Bank of Finland or a deposit bank with the restriction that if the issuer is a deposit bank the cash deposit may not be in a deposit bank belonging to the same consolidation group as the issuer.

ABS or MBS tranches are not eligible for the cover pool.

Derivatives are eligible for the cover pools only if they are used for hedging purposes.

The nature of the cover pool is dynamic. Currency risk is perfectly matched as the law requires cover assets to be in the same currency as the covered bonds.

#### **IV. VALUATION AND LTV CRITERIA**

The property valuation within the legal framework for covered bonds in Finland is based on market values, valuations are based on "current value", market value determined in accordance with FFSA regulations. Based on the updated regulation, the issuer needs to monitor the valuation of the property also based on statistical methods (indexed value) quarterly and set limits for the acceptable changes of the values. Should the value exceed or drop below the limits the property valuation needs to be updated accordingly.

There are different LTV levels for residential and commercial mortgage loans: 70% of the value of the residential property and 60% of the value of the commercial property accepted. This LTV is a relative limit, i.e. when a loan exceeds the 60%/70% limit, the part of the loan up to 60%/70% LTV remains eligible to the cover pool. A loan placed as collateral for a covered bond may not exceed the current value of the property standing as collateral.

#### **V. ASSET – LIABILITY MANAGEMENT**

There are legal standards for Asset-Liability Matching in the Finnish Covered Bond System. For instance, the aggregate interest received on the cover assets in any 12-month period must exceed the interest paid on the outstanding covered bonds. This regulation takes derivatives for hedging purposes into account.

The total amount of collateral of covered bonds shall continuously exceed the remaining combined capital of the covered bonds.

The net present value of the total amount of collateral of covered bonds shall continuously exceed by at least 2% the total net present value of the payment liabilities resulting from the covered bonds. The net present value test helps mitigate interest-rate, currency and liquidity risk.

As mentioned above, interest receivable on cover assets must be sufficient to cover interest payable on covered bonds on a twelve month rolling basis. Moreover, the test needs to be stressed by +/- 1%. In case of a breach of one of these rules mentioned, the issuer might face sanctions from the FSA. Ultimately, the issuer might face the loss if its licence. In addition to the 2% net present value legal minimum, further OC may be

committed by contract. Non-performing loans (defined as 90 days past due) are excluded from cover tests. Assets that are ineligible for Finnish covered bonds (.e.g. non-performing loans) are excluded from the cover tests, but can be retained in the cover pool and lead to additional OC.

## **VI. TRANSPARENCY**

The annual and interim reports of the issuer indicates, in addition to that provided in the act on Credit Institutions, the basis of the valuation of the collateral and the amount of residential mortgage loans and possible intermediary loans and public sector loans issuer has granted, as well as the amount of covered bonds issued.

While there are no statutory transparency rules, Finnish covered bond issuers have adopted the ECBC Label initiative for Covered Bonds and created Finnish National Transparency Template:

<https://coveredbondlabel.com/issuers/national-information/>.

The ECBC Label Transparency Guidelines included in the Covered Bond Label Convention for 2014 are fully aligned and compliant with Art. 129 (7) CRR.

On top of the regulatory requirements all issuers provide additional information about the cover pools, ratings and other relevant topics on their websites. Please find the website information at section X, Additional information.

## **VII. COVER POOL MONITOR AND BANKING SUPERVISION**

The issuer carries out the monitoring of the cover pool. The issuer reports to the FSA on a monthly basis. With regard to UCITS 52(4), this supervision of a specialised bank as issuer of the covered bond is compliant to the "special supervision". The FSA is responsible for overall supervision, covered bond licensing, issuing regulations and compliance with the law.

The FSA has the legal power to take appropriate measures. It is allowed to conduct inspections at the bank in question or to require documents. Also, the FSA could issue a public warning or admonition. Ultimately, it is up to the FSA to revoke the banking licence of the bank in question.

With regard to UCITS 52(4), this supervision of a specialised bank as issuer of the covered bond is compliant to the "special supervision".

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

A cover register allows identifying the cover assets. The legal effect of a registration of assets into the cover register is to create the priority claim of covered bond holders to these cover assets in case of an insolvency of the issuer. The cover register is managed by the corresponding bank, which in turn is supervised by the FSA.

The cover register contains information about the principle amount of covered bonds issued, the mortgages and substitute assets covering these bonds as well as derivative transactions hedging these bonds or funds placed as their collateral. The Finnish covered bond law specifically excludes set-off against cover pool assets. The law also specifically excludes claw-back risk.

### **Asset segregation**

The cover pool is a part of the general estate of the bank as long as the issuer is solvent. If the insolvency proceedings are opened, by operation of law, the assets recorded in the cover registers are excluded from the general insolvency's estate. When the insolvency proceedings are opened, the FSA appoints a special cover pool administrator. Within the insolvency procedure, the derivative counterparties rank pari passu to covered bond holders. The cover assets do form a separate legal estate, which is ring-fenced by law from other assets of the issuer.

### **Impact of insolvency proceedings on covered bonds and derivatives**

Covered bonds do not automatically accelerate when the issuing institution becomes insolvent. The legal consequences for the derivatives in case of an insolvency of the issuing bank depend on the relevant contracts.

The cover pool administrator can only accelerate the covered bonds if the cover tests can no longer be fulfilled. This would trigger the sale of the cover pool assets.

Following issuer default, the regulator is not a manager or servicer of last resort. However, a cover pool supervisor is appointed to supervise the interests of covered bondholders, with powers to direct the issuer's general administrator.

The cover pool supervisor will supervise cover pool cash flows and payments to covered bondholders. The general administrator also has powers to act in the interests of the covered bondholders under the direction of the cover pool supervisor. This includes the ability to assign the liability for a covered bond as well as the related cover pool assets to another licensed covered bond issuer (with the permission of the FSA).

### **Preferential treatment of covered bond holders**

Covered bond holders enjoy a preferential treatment as the law stipulates the separation of the cover assets on the one hand and the insolvency's estate on the other.

The satisfaction of the covered bond holders is not limited to the cover assets in the Finnish system. On the contrary, those creditors also participate in the insolvency proceedings in respect of the remaining assets of the bank.

A moratorium on the insolvency's estate cannot delay the cash flows from the cover assets and, therefore, endanger the timely payment of covered bond holders.

### **Access to liquidity in case of insolvency**

With the appointment of the cover pool administrator, this person acts on behalf of the covered bond holders. The pool administrator has access to the cover assets. Cover assets may only be disposed with the consent of the FSA. Additionally, the pool administrator has also the first access on cash flows generated by the cover assets. The law foresees a possibility for the pool administrator together with the bankruptcy trustee to take up a loan on behalf of the cover pool to create more liquidity.

Up to 20% of the cover pool may consist of liquid substitute cover assets. Substitute assets are deposits, bonds or guarantees of public sector entities or credit institutions and certain credit insurance. With the consent of the FSA, this limit may even be higher. As all cover assets entered into the cover register are ring-fenced in case of an insolvency of the issuer, this results also in the insolvency remoteness of voluntary over-collateralisation.

Some Finnish covered bonds mitigate liquidity risk via contractual 12 month maturity extensions ("Soft Bullet"). The extension provides additional time for principal amounts to be refinanced. Combined with the interest coverage test, maturity extensions improve the chance that principal and interest payments can be met without refinancing the covered bonds for the first twelve months after issuer default.

## **IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION**

Finnish Covered Bonds comply with the requirements of Art. 52(4) UCITS Directive. 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 (CRR)<sup>1</sup>. Therefore, these bonds are 10% risk weighted in Finland. Following the common practice in Europe, they accordingly enjoy a 10% risk weighting in most European countries.

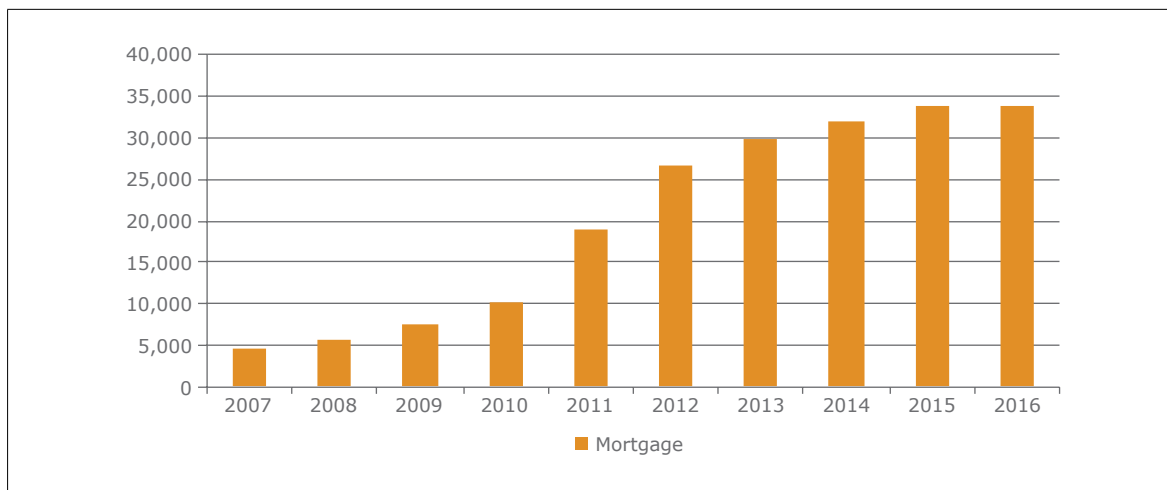
Finnish Covered Bonds are also eligible in repo transaction with national central bank, i.e. within the Euro-zone.

As far as the domestic issuers are aware, there are no further specific investment regulations regarding Finnish Covered Bonds.

---

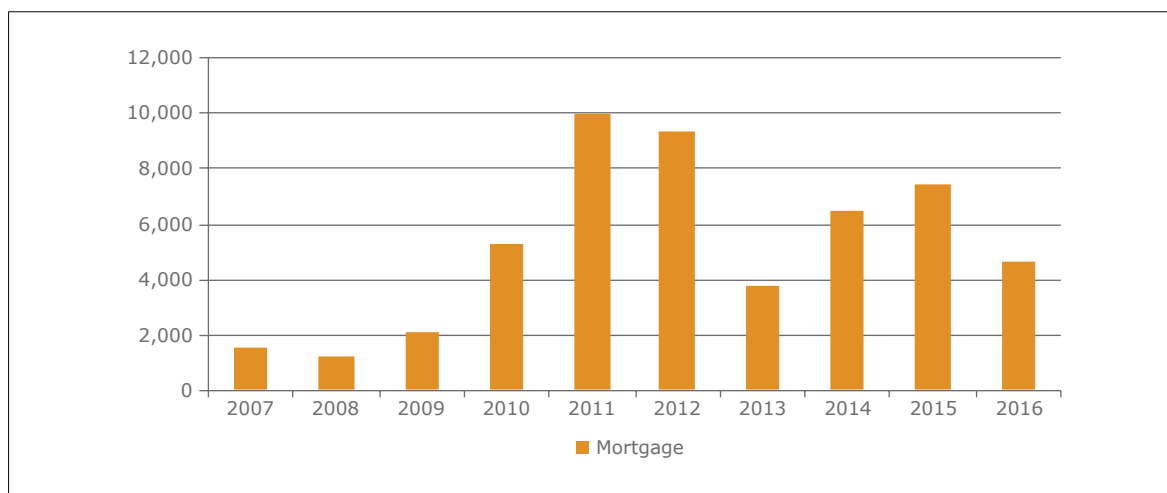
<sup>1</sup> Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): <https://hyppo.org/ecbc/covered-bonds/>.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2007-2016, EUR M



Source: EMF-ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2007-2016, EUR M



Source: EMF-ECBC

**Issuers:** Aktia Bank, Central Bank of Savings Banks Finland, Danske Bank, Nordea Mortgage Bank, OP Mortgage Bank, Alandsbanken, the Mortgage Society of Finland.

**ECBC Covered Bond Comparative Database:** <http://ecbc.eu/framework/19/Finland>.



**COVERED BOND LABEL:** Danske Bank Plc Pool 1; Nordea Mortgage Bank Cover Pool; Op Mortgage Bank, Pool B; Sp Mortgage Bank Plc, SP-01.

