Experiences with the Finnish Act on Covered Bonds

Central European Covered Bond Conference
Copenhagen, 18-19 October 2004

Aktia Real Estate Mortgage Bank plc
Timo Pietilä

Hypoteekkipankki
Hypoteksbank

Contents

UCITS* – the foundation

- The only law at EU level that deals with Covered Bonds
  - A bond is a Covered Bond if UCITS criteria are met:
    - Issuer shall be a EU credit institution
    - Proceeds raised can only be used to acquire eligible assets.
    - Amount of eligible cover assets > Issued covered bonds
    - Bondholders priority claim on the collateral pool in case of issuer insolvency
    - Special public supervision

*Undertaking for Collective Investment in Transferable Securities, Art. 22 (4) 85/611/EEC UCITS Directive

Finnish MBA: Why?

- Expansion – growing need to acquire funding
  - Growth in lending opens up funding gap
  - Deposits the traditional way for funding
- European Union – new bigger internal market
  - Competition of Funds
  - Level playing field
- Euro – new possibilities to attract investor interest
  - No foreign exchange risk

The beginning

- Initiative was taken by major Finnish banks
  - Consultations with Ministry of Finance and Finnish FSA: 1997 -1998
- German law was used as the model
  - Finnish MBA was passed 1.1.2000
  - Result: Good - but not good enough!

The outcome

- The MBA clearly dealt with all the UCITS criteria, but....
- The notching (by Moody's) was only:
  - 1 for mortgage Finnbriefe
  - 2 for public sector Finnbriefe
- Moody's: MBA had weaknesses in asset and liability management issues

Lesson 1: ALM is important

- Quality of the cover pool: Key questions
  1. What is the quality of cover assets
     - Eligibility, valuation, register
  2. Cover assets in case of bankruptcy
     - Separation of pool & priority claim
  3. Management of cover assets
     - How is the pool managed
     - Value of cash flows
  - Number 1 and 2 was regulated, not number 3!

Improvement of the MBA

- The new "benchmark" law set the trend
  - Irish covered bond law
- New ALM guidelines emerged
  - Pre-ruling by rating agencies & regulator
- MBA amendment was passed in 2003
  - Finnish MBA is broadly in line with other European covered bond jurisdictions

Lesson number 2: Extensive preparation

- Start dialogue with CB community at an early stage of the process
  - Test your case before talking to law maker
- The rules of the game changes all the time
  - Make sure you understand the requirements
- Look for best practices
  - "You do not have to invent the wheel again"

Key Strengths of the MBA

- Bond holders have an enforceable priority claim
- No acceleration as long as eligibility criteria are respected
- Asset quality reduces severity of loss
- Credit risk reduced by 10% cap on commercial Real Estate
- Asset & Liability management guidelines
- Substitute collateral provide flexibility in risk management
- Derivatives are registered in the cover asset pool
- Specialist banking principle

Comparing Notching Gaps

ISSUE	NATIONAL LEGISLATION Y/N	STRUCTURED Y/N	MORTGAGE COVERED BONDS' NOTCHING BY MOODY'S
UK Structured Covered Bonds	No	Yes	n.a.*
Mortgage Pfandbriefe	Yes	No	4**
Obligations Foncières	Yes	No	3
Cédulas Hypotecarias	Yes	Some	2***
Irish ACS	Yes	No	2***
Finnish Covered Bonds "Finnbriefe"	Yes	No	2
Aktia Structured Covered Bonds	Yes	Yes	4

- Aktia Mortgage Bank SCB has the maximum four-notches rating gap, which is similar to Germany

* No explicit notching is disclosed, though 4 - 8 is implied for HBOS. **Rating floor of Aa2 as long as minimum C Financial Strength Rating.
***Based on standard notching in Spain and expected notching for Ireland.

Aktia
Hypoteekkipankki
Hypoteksbank

Main CB Markets and Their Key Characteristics

	Finland CBs	France CBs	Germany CBs	Ireland CBs	Spain CBs	UK SCBs
Special Bank Principle	Yes	Yes	Yes	Yes	No	No
LTV Residential	60 %	60-80%	60 %	75 %	80 %	60-75%
Limit on Commercial RE	10 %	No	No	10 %	No	0%*
Max subsititution assets	20 %	20 %	10 %	20 %	n.a.	No
Risk Weighting	10 %	10 %	10 %	10 %	10 %	20 %
Eligible for ECB refinancing	Yes	Yes	Yes	Yes	Yes	Yes

* Based on HBOS.

- The Finnish framework compares well with the established Covered Bond markets in Europe

Issuance activity

- Three mortgage banks in Finland
- Issuance has been limited
  - Domestic issues for retail markets
    - Outstanding amount: Eur 100 million
  - The Aktia deal was the first CB for international markets
    - Eur 1 billion issuance programme
    - Rating: Aa2
    - Outstanding amount: Eur 250 million

Summary

- UCITS sets the minimum requirement
- The Finnish MBA comply with UCITS
- Covered Bond law is strongly recommended for new markets
- Asset and liability management do matter
- Build your case with help of the CB community
- Aim for quality & transparency

Appendices

- The Finnish Covered Bond Law
  - Insolvency procedure
  - Asset and Liability management limits

The Finnish Covered Bond Law (i)

- The issuer will be segregated from a parent bank insolvency estate
- In case of issuer bankruptcy the outstanding covered bonds and the respective collateral pool in addition to derivatives are segregated from the insolvency estate
- FCB would not be accelerated in a bankruptcy procedure
- FCB holders have a priority claim on all mortgage assets registered as collateral
- FCB holders maintain their priority claim as long as there is a payment due
- If the covered bond holders have not been satisfied in full out of the cover assets, then they still have a valid claim for the remainder on the issuer, ranking pari-passu with other senior creditors
- An insolvency/bankruptcy of FCB issuer does not constitute a termination event of the derivatives registered as collateral
- These derivatives would remain part of the collateral pool and would remain in place

The Finnish Covered Bond Law (ii)

- If a mortgage bank is declared bankrupt, a Special Attorney is appointed by the Finnish Financial Supervision Authority (FSA), to represent the interests of the FCB holders
- At the same time the court in the insolvency proceedings appoints a bankruptcy administrator
- The Special Attorney supervises the management of the assets placed as collateral for the FCB and their potential conversion into cash, as well as the contractual payments to be made to the holders of the FCB
- The bankruptcy administrator may not, sell or transfer any assets placed as collateral for the FCB without the prior permission of the Special Attorney and the FSA
- The administrator may, with the permission of the Special Attorney, transfer the liability for FCB together with the respective cover pool to another domestic or foreign mortgage bank, subject to supervision corresponding to that under the MBA

The Finnish Covered Bond Law / ALM Limits

- Duration of covered bonds and cover asset pool
  - **Limit:** The average duration of covered bonds should always be shorter than the duration of cover asset pool

- Interest rate risk of pool
  - **Limit:** Pool of cover assets and covered bonds should always have positive net interest income in any given 12-month's period, including a 100bp parallel curve shift stress test (up/down)

- Foreign exchange risk of pool
  - **Limit:** Only collateral in the same currency as the covered bond may be entered in the register of the cover asset pool. In addition, if the funding currency were to differ from the currency denomination of the underlying assets, then the foreign exchange risk will have to be hedged with derivatives, so no exposure to foreign exchange risk will result
  - The derivatives will be registered in the collateral pool