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New regulations for covered bonds

Summary

Covered bonds are governed by the Covered Bonds (Issuance) Act (2003:1223) and Finansinspektionen's regulations and general guidelines (2004:11) regarding covered bonds. As a result of amendments to the law and a general need to review the current regulations, Finansinspektionen is deciding on new regulations and general guidelines regarding covered bonds.

The provisions in the current regulations and general guidelines will to some extent be transferred to the new regulations and general guidelines. The new regulations and general guidelines include amendments to the issuing institution's revaluation of collateral for loans included in the cover pool, the implementation of sensitivity analyses for changes to prices of property used as collateral for mortgage loans in the cover pool, requirements on counterparties in derivative agreements and the independent inspector's assignments.

The new regulations and general guidelines will enter into force on 1 July 2013, at which time the current regulations and general guidelines will be repealed.

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1 Introduction

1.1 Current situation

Covered bonds are debt securities issued by banks or specialised credit institutions where the bond holders receive a specific right of priority to a cover pool if the issuer is subject to foreclosure or enters into bankruptcy. This cover pool primarily consists of home loans, but it may also consist of government bonds and other mortgage loans, e.g. agricultural loans. The Swedish banks make considerable use of this source of funding and the total outstanding debt corresponds to around SEK 2,000 billion (the bonds are also issued in other currencies).

Covered bonds have received more attention as a safe investment since confidence in other investments has decreased following the financial crisis.

1.2 Current and pending regulations

The Covered Bonds (Issuance) Act (2003:1223) (CBIA) entered into force on 1 July 2004 and has since then been amended on several occasions. One of the most important amendments was in 2010 when the asset manager was given greater authorities in the event of bankruptcy.[1]

Finansinspektionen's regulations and general guidelines (2004:11) regarding covered bonds entered into force on 15 October 2004 and since then have not been amended. Finansinspektionen's new regulations and general guidelines will be updated to reflect the implemented amendments to the law and they will also be reviewed in general.

A number of projects are currently underway that could be relevant for covered bonds. Covered bonds are regulated, for example, in capital adequacy contexts, where there are rules for how such bonds should be risk weighted and the extent to which they may be included as assets in the pending European and national liquidity requirements. New rules are also pending in this area in conjunction with the implementation of the EU's capital adequacy regulatory framework (CRR/CRD 4[2]).

[1] SFS 2010:320.

[2] Capital Requirements Regulation/Capital Requirements Directive 4.

Finansinspektionen is also participating in working groups under the European Banking Authority (EBA) that are working with regulation of covered bonds.

A private initiative has also been started by the European Covered Bond Council (ECBC), and industry organisation, to create common criteria for covered bonds within the EU.

As mentioned above, there is currently a need to update Finansinspektionen's regulations and general guidelines regarding covered bonds. Given this background, it is not appropriate to wait for the results of the international discussions and update Finansinspektionen's regulations and general guidelines once the European framework is finally in place.

The new regulations and general guidelines shall enter into force on 1 July 2013, at which time the current regulations and general guidelines will be repealed.

1.3 Objective of the regulation

The general objective of the new regulations is to create a clearer and more effective regulatory framework for covered bonds. The regulations aim to supplement the provisions of CBIA as well as guide institutions and the independent inspector through the issuance and inspection of covered bonds.

A well functioning regulatory framework for covered bonds may contribute to lower funding costs for issuing institutions, which may also improve consumers's opportunities for obtaining cheaper home loans. More precise rules for institutions and effective supervision make these securities more transparent and safer for investors. Since covered bonds are a very important source of funding for a number of large Swedish banks, confidence in them is also important for the Swedish financial system as a whole.

1.4 Legal conditions

The new regulations are submitted pursuant to authorisations set out in Chapter 5, section 2, point 4 of the Banking and Financing Business Ordinance (2004:329) and section 1 of the Covered Bonds (Issuance) Ordinance (2004:332).

1.5 Regulation alternative

Due to amendments to the laws in this area, there is a need to amend the current regulations which, among other things, contain incorrect references to CBIA. In addition, Finansinspektionen has made the assessment based on the lessons learned over the past few years that the regulations regarding the issuing institution's administration and the independent inspector's supervision of covered bonds need to be reviewed and updated.

As a whole, Finansinspektionen does not believe that there is a better alternative to issuing new regulations and that issuing new regulations is the simplest and most appropriate way to create a clear, effective regulatory framework for the area.

1.6 Preparation

Finansinspektionen drafted the new regulations in part by obtaining feedback from an external reference group consisting of representatives from the Swedish Bankers' Association, an independent inspector and a representative from one of the large credit rating institutions.

A proposal for the new regulations and general guidelines was submitted for consultation on 2 July 2012. The following commentators gave us feedback about the proposal:

- The Swedish Bankers' Association, which, however, allowed the Association of Swedish Covered Bond Issuers (ASCB) to submit the comments. According to ASCB itself, ASCB represents the members within the Swedish Bankers' Association that issue covered bonds as well as Landshypotek.
- Swedish Accounting Standards Board
- Data Inspection Board
- The current independent inspectors - Gösta Fischer, Sven Höglund, Jan Palmqvist, Sussanne Sundvall (Inspection Group)
- FAR SRS
- Association of Swedish Finance Houses
- Swedish Competition Authority
- Regulation Board
- Swedish National Savings Banks Organisation
- Sveriges Riksbank

Five commentators (ASCB, Inspection Group, Association of Swedish Finance Houses, Regulation Board and Sveriges Riksbank) submitted feedback on the consultation proposal.

After the consultation, Finansinspektionen revised the proposed regulations to take into consideration the feedback from the commentators. The most significant points of feedback were discussed in the manner set out below in each section. The regulations and general guidelines also underwent editorial revision.

2 New regulations and general guidelines regarding covered bonds

Finansinspektionen presents below the relevant parts of the amendments and additions that were decided in relation to the current regulations and general guidelines regarding covered bonds.

2.1 Application for authorisation to issue covered bonds (Chapter 2)

Finansinspektionen's position:
The provisions regarding the content of an application for authorisation will be transferred more or less unchanged to the new regulations. A new requirement will be introduced that requires the financial plan to be prepared in line with the forecasts the firm made in its internal capital adequacy assessment process (ICAAP).

Other requirements on the content of the application for authorisation will be transferred to the new regulations with only editorial changes.

Consultation memorandum:
Contained more or less the same proposals.

Commentators:
Had no objections in the matter.

Finansinspektionen's grounds:
The current regulations state that the financial plan, which shall safeguard that the interests of other creditors are not jeopardised, shall refer to the next three years. In addition to this, the new regulations implement that the financial plan shall be prepared in line with forecasts from the firm's own internal capital adequacy assessment process. This requirement will better anchor the financial plan in the issuing institution's total operations. It is also judged to be reasonable that the financial plan in the application for authorisation to issue covered bonds agrees with the financial plan that an institution submits in its internal capital adequacy assessment process.

2.2 Cover pool requirements (Chapter 3)

The new regulations amend how the control and valuation of collateral may be carried out and clarify in the general guidelines the type codes that may be used to determine the intended purpose of a mortgaged property. In addition, Finansinspektionen is implementing a requirement that the issuing institution shall conduct a sensitivity analysis of future changes to the market values of the underlying collateral for loans, i.e. mortgage property.

Intended purpose for the mortgage property (Chapter 3, section 1)

Finansinspektionen's position:
Current general guidelines regarding the determination of the intended purpose for a mortgage property will be transferred to the new regulations. The guidelines are supplemented with a provision that an institution, in the event that the type codes from the land register's taxation information are no longer relevant, may establish fairer grounds for its assessment in collaboration with Finansinspektionen.

A corresponding assessment of the purpose that is used for mortgage property in Sweden should also be used for foreign mortgage properties. This assessment should be documented.

Consultation memorandum:
Contained more or less the same proposals.

Commentators:
ASCB has suggested that the general guidelines should be applied to foreign mortgage properties "with the changes that are motivated by the conditions in the country where the mortgage property is located".

Finansinspektionen's grounds:
Pursuant to Chapter 3, section 3 of CBIA, a mortgage loan may be included in the cover pool at different grades (loan-to-value ratios) depending on the intended purpose of the property. In order to determine the intended purpose of a mortgage property, Finansinspektionen provides guidance to the issuing institutions via the general guidelines.

The current general guidelines stating that if an institution, when assessing the intended purpose of a mortgage property, may seek guidance in the type codes that are found in the land register are transferred more or less unchanged to the new guidelines. An addition was made that entails that an institution, in the event that the type codes from the land register's taxation information are no longer relevant, may establish fairer grounds for its assessment in collaboration with Finansinspektionen. One reason for why the type codes are no longer relevant may be that they are no longer updated regularly or for other reasons do not correctly reflect the purpose of the property.

The general guidelines should also be applied when determining the purpose of foreign mortgage properties that are not covered by the land register in Sweden. Finansinspektionen believes that the change in wording suggested by *ASCB* would allow too much flexibility in the application of the provision with regard to foreign mortgage property.

Finansinspektionen believes accordingly that with regard to foreign mortgage property, the establishment of fairer grounds for the assessment shall occur in

collaboration with Finansinspektionen. The wording of the provision is therefore not changed.

The issuing institution should document the assessment of the purpose for the foreign mortgage property. The reason for this is that the grounds for the assessment can fluctuate more than for a domestic property.

Fire insurance

Finansinspektionen's position:
The current regulations regarding fire insurance will be removed.

Consultation memorandum:
Contained the same proposals.

Commentators:
Received no feedback.

Finansinspektionen's grounds:
Borrowers shall guarantee at the time the loan is granted that the property is covered by fire insurance. It is not reasonable to require that the issuing institution has full control at all times that the buildings belonging to the properties are covered by fire insurance. The cost of the institutions always being aware of whether the fire insurance is valid is not considered to be offset by the expected losses that fires can cause in properties that are not covered by fire insurance. The provision in the current regulations that buildings belonging to properties and site leasehold rights shall be covered by fire insurance to allow mortgage loans to be included in the cover pool is therefore removed.

How to control market value (Chapter 3, section 5)

Finansinspektionen's position:
The new general guidelines state that the value of the collateral may be adjusted upward, where applicable, and that every instance of appreciation should be thoroughly documented. If an institution has chosen to adjust the value upwards, depreciations should also be registered correspondingly.

The independent inspector shall review the revaluations of underlying collateral that the institution has made during the year and report on them in the inspection report.

Consultation memorandum:
Contained more or less the same proposals.

Commentators:
ASCB points out that, even when an issuing institution chooses to revalue collateral beyond the requirements set out in Chapter 3, section 5, it is important that the institution has the option of not adjusting the value upward.

Finansinspektionen's grounds:
A central part of the regulations regarding covered bonds is the regulation of the valuation of collateral for loans. Finansinspektionen is therefore implementing general guidelines that state how the issuing institution may choose to revalue mortgage property on a regular basis.

Pursuant to Chapter 3, section 4 of CBIA, an issuing institution shall establish the underlying market value of collateral in conjunction with the issuing of a mortgage. The market value shall foremost be determined via an individual valuation, but in some noted cases a valuation may be based on general price levels.

In accordance with Chapter 3, section 7 of CBIA, the issuing institution shall regularly monitor the market value of property that serves as collateral for mortgage loans. If the market value of such property has fallen significantly, the amount at which the mortgage loan may be included in the cover pool may be adjusted downward. It is therefore of utmost importance that significant price falls are monitored and entered into the register.

That said, for practical reasons it is not possible for the institutions to have complete control on an ongoing basis of price falls in all of the underlying collateral. A limit of a 15 per cent price drop was therefore mentioned in the preparatory work for CBIA (Prop. 2002/03:107, p. 107), where the firms must enter the lower value in the register. However, it is not expressly stated in either the law or the preparatory work what applies to appreciations in value.

It is not considered reasonable that the collateral for older mortgage loans must have a valuation that may not appreciate at all. Appreciation should be allowed, for example after prices have recovered from a major drop that was registered in accordance with Chapter 3, section 7 of CBIA. The result is otherwise a lower value in the register, which is a disadvantage for holders of covered bonds since the cover pool becomes smaller. However, it is important that appreciation, particularly with regard to appreciation in index values, is not recorded without strong justification.

In summary, Finansinspektionen believes that appreciation in the value of the collateral's registered market value should be allowed to happen, but that the rules for such appreciation should be restrictive. It should also be clearly stated that the institution shall not be obligated to conduct revaluations except for significant price falls in accordance with Chapter 3, section 7 of CBIA.

If an institution has chosen the appreciation option, depreciations in value should be correspondingly registered, i.e. not just in situations where the price falls up to 15 per cent. This means that if the issuing institution chooses to register small appreciations in value, it should also register small depreciations in value. An institution therefore has the option of refraining from registering

appreciations in value. The method that is chosen should be consistent over time. Otherwise, the institutions may opt to revalue only when prices have risen.

One problem with overvalued collateral, for example as a result of valuations based on general price levels, is that it gives investors a false sense of security. This can in turn damage confidence in general for covered bonds, which can cause problems on the financial markets.

It can be noted in this context that credit rating institutions normally conduct their own analyses of the issuing institutions' loan-to-value ratios based on indexed values of the collateral, and that these calculations are part of the assessment for which credit rating will be assigned to the bonds.

If, from the start, the cover pool includes loans that are only partly included, an appreciation in the value of collateral can also result in an increase to the size of the cover pool since a larger part of the loans may be included. However, the cover pool may never be larger than the total value of the loans.

Each instance of appreciation should be carefully documented. The independent inspector shall review the institution's positions for revaluations of underlying collateral that the institution has made during the year and report on them in the inspection report.

Sensitivity analysis (Chapter 3, section 6)

Finansinspektionen's position:
The issuing institution shall conduct sensitivity analyses.

Consultation memorandum:
Contained more or less the same proposals.

Commentators:
ASCB questions the introduction of a specific level requirement into the regulations for the fall in prices at which tests shall be carried out. A stress test expressed in this way can easily be understood to be an OC requirement ("*over collateralization*"), which means requirements on additional collateral in the cover pool. According to ASCB, all issuing institutions "*currently have OC*", but the level is individual and steered by multiple parameters and requirements from both investors and credit rating institutions. ASCB suggests that the second paragraph in section 6 of the consultation proposal be changed and that the test be held on several levels and against matching requirements.

ASCB also suggests that the result of the sensitivity analysis be included in the information that will be given to the independent inspector.

Finansinspektionen's grounds:

The issuing institutions in general are already conducting sensitivity analyses to a greater extent, but Finansinspektionen aims through this provision to ensure that all institutions conduct standardised sensitivity analyses of the market values of collateral for mortgage loans (properties, site leasehold rights and tenant-owner rights). The sensitivity analysis can also be a tool for the independent inspector in the inspection of the internal control for covered bonds. The design of the regulations was based on how firms today conduct similar analyses in accordance with Chapter 44, section 24 of Finansinspektionen's regulations and general guidelines (2007:1) regarding capital adequacy and large exposures.

Finansinspektionen does not share the view that the sensitivity analysis should be conducted "on multiple levels and against the matching requirements" as suggested by *ASCB*. This expression is not sufficiently clear and there is a risk that the tests will be conducted somewhat arbitrarily. Finansinspektionen, however, taking into consideration the comments from *ASCB*, has adjusted the provision so that the sensitivity to price falls is not be tested only at one level but rather at a number of different pre-determined levels. In addition, Finansinspektionen is taking ASCB's feedback into consideration in that it is introducing a requirement that the results of the sensitivity analysis shall be sent to the independent inspector. As set out in Chapter 6, section 7 of the new regulations, the independent inspector shall report on the issuing institution's sensitivity analyses in an annual report to Finansinspektionen .

The purpose of the sensitivity analysis is not to introduce an implied requirement on additional collateral. The idea, rather, is that every issuing institution should both conduct standardised sensitivity analyses and prepare measures that will ensure that the institution can handle the effects that falling property prices have on the matching between the outstanding bonds and the cover pool.

Action plan

Finansinspektionen's position:
The report on the sensitivity analysis shall include measures showing how the issuing institution can improve its matching, if needed.

Consultation memorandum:
Contained a requirement to prepare an action plan if the sensitivity analysis shows that the institution would not meet the matching requirements in the event of falling prices. The action plan would describe how the issuing institution intended to improve the matching.

Commentators:
ASCB suggests that the action plan requirement be removed and that the issuing institution shall instead inform the independent inspector about the results of the sensitivity analysis. The organisation's motivation for this is that the action plans proposed in the consultation version could be misinterpreted by the market and lead to an over-reaction, which in turn could cause problems

for institutions and generally increase volatility and uncertainty. The fact that a participant, when conducting a sensitivity test, cannot handle the matching requirements in a situation with falling asset prices does not normally mean, according to ASCB, that there are problems with either stability or the institution's ability to meet the requirements of the law.

Finansinspektionen's grounds:
The purpose of introducing a requirement to prepare an action plan was primarily to assist the institution with its internal governance, risk management and control. Finansinspektionen, however, understands *ASCB's* viewpoint that the institutions may be stigmatised if they must prepare and submit an action plan. The previously proposed provision is therefore removed. Finansinspektionen prescribes instead in section 6 that the report on the sensitivity analysis shall include measures showing how the institution can improve matching in the event of falling prices.

It is reasonable to assume that the institutions are already planning today for how they can maintain matching during the daily calculation. Both the current and the pending regulations have requirements that matching shall be maintained in the event of unfavourable interest rate and currency changes, if this is not hedged by derivative agreements. It is also reasonable that the institutions describe the measures the institution can take in the event of falling property prices. This kind of description can contain measures that an issuing institution may take to fulfil the matching requirements. However, the intention is not to regulate in detail which measures the issuing institutions must take in practice since this depends on specific conditions.

2.3 Conditions for derivative agreements and calculation of and terms and conditions for risk exposure and interest payments (Chapter 4)

Matching rules (Chapter 4)

Finansinspektionen's position:
The current general guidelines stating that the book value of any derivative agreements should be used in matching are transferred to the new regulations.

However, the proposed general guidelines in the consultation version for the provision in Chapter 3, section 8 of CBIA which states that the current book value should be used for covered bonds and substitute collateral in the nominal matching calculation have been removed.

Consultation memorandum:
Proposed only one language and editorial change to the current general guidelines for the matching rules in Chapter 3, section 8 of CBIA.

Commentators:
The *Inspection Group*, i.e. the current independent inspectors, point out that because the book value of 1. lending transactions, 2. substitute collateral and 3.

derivatives varies based on the options presented within the accounting regulations (IAS 39) the same equation will look different for different institutions depending on the combination of 1–3. The book value for these posts may namely be determined by the bank's choice of amortised cost, adjusted amortised cost (if hedge accounting for fair value is applied) or fair value. This means that there are nine possible combinations. Within the framework of these combinations each institution can make its own choices. The Inspection Group considers there to be no motivation for the fact that the choice of valuation principle affects the determination of the asset pool and suggests that the same adjustments that are found in FFFS 2007:1 with regard to the determination of own funds shall also apply here.

The Inspection Group also states in a supplement to its original comment that the general guidelines regarding the book value of bonds and substitute collateral should be removed. However, they believe that the book value should be used with regard to any derivative agreements.

Finansinspektionen's grounds:
Since Chapter 3, section 8 of CBIA clearly states that it is the nominal value that shall be used, Finansinspektionen does not believe that this needs to be developed. However, the general guidelines which state that derivative agreements should not be included in the nominal value but rather in the book value are transferred to the new regulations. With regard to bonds and substitute collateral, Finansinspektionen shares *the Inspection Group's* opinion. The reason for this is that in the nominal matching, hedges (derivative agreements), primarily regarding changes in foreign exchange rates, should be included at book value.

Present value calculation (Chapter 4, section 2)

Finansinspektionen's position:
The current provision regarding present value calculation is transferred to the new regulations with two changes; the reference to "*zero-coupon rates*" and the phrase "*or to another rate curve that generally is used for defining the interest rate*" have been removed.

Consultation memorandum:
Contained proposals that an issuing institution when calculating the present value should take into consideration all risks associated with the instruments that will be valued.

Commentators:
ASCB does not see any reason to change the current provision regarding the present value calculation. The reason for this is that it questions the underlying theory of the proposed present value calculations. The consultation memorandum proposed that both assets and liabilities be divided into classes. The present values for the classes are then calculated using specific discount rates per class. The purpose of this procedure is calculate more accurate present values and to make it easier to compare different institutions. However, ASCB

believes that the proposed model is too complicated and contributes to neither the law's nor the regulations' purpose with regard to matching present values. It points out that there are not enough rates to be used as discount rates for the different classes and different types of risk. According to ASCB, the system would become much too complex and this would make it difficult for anyone to draw any conclusions about the results.

Finansinspektionen's grounds:
Finansinspektionen has now determined, after taking into consideration *ASCB's* feedback, that discounting for all risks can make the present value calculation unnecessarily complicated. Finansinspektionen therefore returns to the reference, as in the current regulations, to the swap rate curve for the currency in question, but removes the reference "*or to another rate curve that generally is used for defining the interest rate*", since Finansinspektionen believes that this formulation is too flexible and allows a choice of which rate curve to use, which in turn decreases comparability between the institutions. Finansinspektionen considers the term "zero-coupon rates" to be superfluous and believes that it can be removed since the swap rate curve normally is a "zero-coupon rate".

Interest rate and currency risks (Chapter 4, sections 3 and 4)

Finansinspektionen's position:
The current provisions regarding interest rate and currency risks are transferred to the new regulations with minor changes. The provision regarding interest rate risks (section 2 in the current regulations) is transferred to the new regulations with the change that the reference to the phrase "*or to another rate curve in accordance with section 1"* is removed.

Consultation memorandum:
Contained more or less the same proposals. However, the provision was reformulated.

Commentators:
Received no feedback.

Finansinspektionen's grounds:
The current regulations state that the requirement on calculating the present value of the cover pool's assets shall also be fulfilled after a one percentage point change to the discount rate curve both upward and downward. For currency risks the requirement is that the calculation of the present value should take into consideration a ten per cent change in the relationship between the bond currencies and the asset currencies. The provision is transferred to the new regulations with the clarification that it clearly states that the requirement shall be fulfilled even for changes in the most unfavourable direction. Therefore, the phrase "*or to another rate curve in accordance with section 1*" is removed. In addition, the words "*sudden and sustained*" are removed since they do not add anything given the context.

The new wording does not alter the meaning in any way.

Termination of derivative agreements (Chapter 4, section 7)

Finansinspektionen's position:
The current provisions regarding the termination of derivative agreements are transferred to the new regulations with only editorial changes.

Consultation memorandum:
Contained the same proposals.

Commentators:
ASCB says that the provision is much too strict and as a result central counterparties might not accept these types of derivatives. The organisation suggests that the last part of the section be deleted and only regulate that the agreements may not be terminated as a result of bankruptcy.

Finansinspektionen's grounds:
Finansinspektionen firmly believes that it should not be possible to terminate an agreement prior to an eventual bankruptcy. If the regulations are limited in the manner suggested by *ASCB* there is a risk that the protection against derivative agreements being terminated in conjunction with an eventual bankruptcy may be undermined. Derivative counterparties should not be able to terminate an agreement as eventual bankruptcy approaches, since this is just when the protection is needed.

Counterparties in derivative agreements (Chapter 4, section 8)

Finansinspektionen's position:
An issuing institution may only enter into derivative agreements with a counterparty that at the time the agreement is entered into has a publicly recognised credit rating from a qualified rating institution at a level not less than that set forth in the table in the regulations. The new regulations, in contrast to the current regulations, only contain requirements on the long-term credit rating. These regulations refer to derivative agreements that the institutions enter into for their risk management and to fulfil the matching requirements set out in Chapter 3, sections 8 and 9 of CBIA.

Just like in the current regulations, a derivative agreement may be entered into with a counterparty that has a credit rating that does not meet the minimum requirement only if the counterparty fulfils the requirements regarding credit ratings from two other credit rating institutions.

The provision regarding what happens if a credit rating institution changes the designations in its assessment scales are transferred to the new regulations without the phrase "*or creditworthiness requirements in order to reach a certain credit rating*".

The general guidelines under Chapter 4, section 7 of the current regulations regarding preventive measures are removed from the new regulations.

Consultation memorandum:
Contained the same proposals.

Commentators:
ASCB believes that a requirement linked to a certain credit rating is incorrect and can lead to system-wide risks. The background to this comment is the criticism the credit rating institutions received after the financial crisis combined with the fact that financial market participants depended too heavily on external ratings from these institutions instead of conducting their own analyses of their counterparties. ASCB believes that it is a mistake when reviewing the regulations to once again build a link to an external credit rating and that this goes against the regulation trends in the EU. ASCB is also concerned about what would happen if a larger counterparty suffered a downgrade to its rating, which would mean that the counterparty is no longer acceptable within the regulatory framework. In addition, it believes that the regulation becomes unnecessarily rigid if, for example, the market changed and an AA rating became the new standard for covered bonds. ASCB is therefore suggesting that all references to credit rating institutions be removed from the regulations.

Finansinspektionen's grounds:
The current provisions state that the counterparty in a derivative agreement that the issuing institution enters into shall either belong to the categories set out in Chapter 3, section 2 of CBIA or at the time the agreement is entered into have a credit rating from a qualified credit rating institution that is as a minimum in line with that stated in a table in the regulations. The reference to CBIA is, after amendments to the law, no longer up-to-date and provides no guidance for which categories of counterparties are referred to. Furthermore, Finansinspektionen believes that it should no longer be possible to arbitrarily use the categories that were previously referred to as derivative counterparties. Finansinspektionen is therefore not transferring this part of the provision to the new regulations.

Finansinspektionen also believes that the reference in the current Chapter 4, section 7, third paragraph to whether credit rating institutions changed their valuation models may lead to uncertainty and should be removed. However, Finansinspektionen retains the provision stating that for situations where credit rating institutions formally change their scales the new designations should be used (Chapter 3, section 8, third paragraph of the new regulations).

The regulations place requirements on the creditworthiness of counterparties in order for institutions to be allowed to enter into derivative agreements with them. The current regulations require that the counterparty have a long-term rating and a short-term rating. The new regulations only require a long-term credit rating.

A short-term credit rating refers in general to a horizon of up to one year. Since covered bonds as a rule have an initial horizon that is longer than one year it is important that the counterparty's long-term credit rating meets the requirements. One argument for also including short-term credit ratings in the table is that it might only be possible to find counterparties with short-term credit ratings. Given the contracts' long maturities, however, such a regulation is not appropriate since the counterparties are expected to meet their commitments during the entire term of the bond.

Finansinspektionen has carefully evaluated *ASCB's* comment that the provision should not refer to credit ratings, but is choosing to keep this link. An important part of the protection for bond holders in the event the issuing institution goes bankrupt is that applicable derivative agreements are fully executed. In order to ensure that derivative counterparties fulfil their commitments in accordance with the derivative agreements, it is very important that the counterparties are creditworthy. If this requirement is removed completely, it must be replaced with another provision that fulfils the same purpose, i.e. that the counterparty is creditworthy in the long term. Such a provision, however, is difficult to formulate without being arbitrary. Finansinspektionen is aware that it can be problematic to be too dependent on the assessments of credit rating institutions. If the uncertainty on the market would become so serious that only a few counterparties are able to live up to the requirement in the regulations, Finansinspektionen would then have the possibility to adjust the levels of the credit rating requirement or grant an exemption in accordance with the provision in Chapter 4, section 10.

With regard to the possible change that covered bonds in the future would be expected to have a credit rating corresponding to at least AA, as indicated by ASCB, it is still very important that the issuing institution's counterparties fulfil their commitments. This possible change is therefore not a reason to completely eliminate the requirements on derivative counterparties.

According to the current regulations, it is sufficient to have an approved credit rating if there are no other ratings from another institution that are under the minimum threshold. If there are other ratings below the minimum requirement then the requirement is that there must be at least two credit ratings above the minimum requirement. This provision is transferred and clarified in the new regulations.

Finansinspektionen removes the general guidelines regarding preventive measures. However, Finansinspektionen expects the institutions to be prepared for a situation where a derivative counterparty's credit rating falls to a level under the requirements that are set out in the new provision in Chapter 4, section 8.

If the derivative counterparty's credit rating is downgraded (Chapter 4, sections 9 and 10)

Finansinspektionen's position:

The issuing institution shall immediately inform Finansinspektionen and the independent inspector if a derivative counterparty's credit rating falls below the requirements set for in the table in the regulations. No new derivative agreements may be entered into with the counterparty without Finansinspektionen's approval.

The issuing institution shall prepare within 90 calendar days a report describing which outstanding derivative agreement the institution has entered into with the counterparty and a plan for how it intends to handle the outstanding derivative agreements.

Derivative agreements with counterparties that do not fulfil the requirements in the regulations regarding credit ratings may be approved by Finansinspektionen where special grounds exist.

Consultation memorandum: Contained more or less the same proposals. However, the memorandum proposed that the time requirement in Chapter 4, section 9 should be 30 calendar days.

Commentators: *ASCB* would like the time requirement in Chapter 4, section 9 extended to 90 calendar days.

Finansinspektionen's grounds:
If a counterparty's credit rating is downgraded below the level stated in the table in the regulations, the issuing institution shall immediately inform Finansinspektionen and the independent inspector. No new derivative agreements may be entered into with this counterparty without Finansinspektionen's approval.

The issuing institution shall also prepare a report describing which outstanding derivative agreement the institution has entered into with the counterparty and a plan for how the institution intends to handle the outstanding derivative agreements. If an institution, at the time the rating of a derivative counterparty is downgraded, has receivables with that counterparty, it is of particular importance for the institution to be able to show how the situation will be resolved. The purpose of implementing the provision is to minimise the legal ambiguities during the application of the regulation. In terms of when the report and plan shall be prepared, Finansinspektionen believes, taking into consideration *ASCB's* feedback, that 90 days should be sufficient since what is most important is that the matching is maintained.

A provision is also introduced stating that Finansinspektionen can approve derivative agreements with counterparties that do not fulfil the requirements in the regulations if there are special grounds. The intention is that this possibility will only be used as an extreme exception. One occasion when Finansinspektionen may need to approve other counterparties is if there are very strong grounds for assuming that an institution can be considered to be just as safe as if they fulfil the requirements. For example, this can apply to some central banks or other public institutions, which maybe do not have a

credit rating, or banks that have undergone changes where there are very strong grounds to believe that credit rating institutions, at the next credit assessment, will give the counterparty a credit rating that fulfils the requirements. Another example can also be that another party with sufficiently good creditworthiness guarantees the counterparty's commitments during current derivative agreements.

Separate account (Chapter 4, section 11)

Finansinspektionen's position:
The general guidelines clarify that the funds which pursuant to Chapter 3, section 9, fourth paragraph of CBIA shall be held separate from other funds should also be separated in the day-to-day accounting.

The issuing institution should ensure that it has an organisation and IT systems that fulfil the requirements for the separate account if the institution enters into bankruptcy.

Consultation memorandum:
Contained more or less the same content.

Commentators:
Had no comments on the matter.

Finansinspektionen's grounds:
The current general guidelines have been revised and reformulated with the aim of clarifying that the requirements to separate funds exist even if the funds are not permanently kept in an account.

2.4 Register (Chapter 5)

Finansinspektionen's position:
The provisions regarding the register in the current regulations are transferred to the new regulations. A new provision is introduced that clarifies that if an issuing institution has different cover pools, all cover pools, and the covered bonds that belong to each cover pool, have separate registers that fulfil the requirements in CBIA and the regulations.

Consultation memorandum:
Contained more or less the same proposals.

Commentators:
Had no comments on the matter.

Finansinspektionen's grounds:
The obligation to maintain a register of covered bonds and the cover pool that is linked to the bonds is an important prerequisite for the possibility to issue bonds against specific collateral. The provisions of the regulations shall

contribute to the creation of clear and effective regulations for covered bonds. The provisions supplement the regulations in CBIA and provide guidance.

In addition, a new provision is introduced that clarifies that if an issuing institution has several cover pools, all cover pools, and the bonds that belong to each cover pool, have separate registers that fulfil the requirements in CBIA and the regulations. CBIA only mentions *one* cover pool. The preparatory work for the law (Prop. 2009/10:132 p. 16 with reference to Ds 2001:38 p. 109 f.), however, states that this does not prevent an issuing institution from establishing several different cover pools. If there are several cover pools, according to Ds 2001:38 p. 110, each cover pool and the associated bonds shall be recorded into separate registers.

2.5 The independent inspector (Chapter 6)

Pursuant to Chapter 3, section 13 of CBIA the independent inspector is tasked with monitoring that the issuing institution's register of covered bonds is maintained properly and in accordance with the provisions of the law. The independent inspection plays a central role in the supervision of the regulation for covered bonds. The purpose of the amendments, compared to the existing regulations, is that the inspection will become more risk-based than before.

Expertise requirements

Finansinspektionen's position:
The current provision on expertise requirements for the independent inspector is not transferred to the new regulations.

Consultation memorandum:
Contained more or less the same proposals.

Commentators:
Received no feedback.

Finansinspektionen's grounds:
Finansinspektionen appoints the independent inspectors. In this process Finansinspektionen places strict requirements on the independent inspector's expertise and that he/she has the appropriate qualifications. When an inspector is appointed Finansinspektionen assesses his/her expertise in financial auditing, IT and systems, law, property valuation and the bond market. These qualification requirements can also be met to some extent by the independent inspector receiving help from others in these areas. Given this background and taking into consideration that Finansinspektionen should not regulate its own actions in its regulations, the provision that an independent inspector shall have appropriate qualifications has not been transferred to the new regulations.

Requirements on independence (Chapter 6, section 1)

Finansinspektionen's position:

The independent inspector may not undertake other assignments in the issuing institution or in other firms within the Group to which the issuing institution belongs. In the event an external audit is conducted by auditors from the same firm as the independent inspector, the inspector shall demonstrate that no conflicts of interest can occur between the independent inspection and the external audit.

Consultation memorandum:
Contained more or less the same proposals.

Commentators:
The *Inspection Group* notes that in Norway, for example, external auditors have been appointed independent inspectors and, according to the Group, this has not resulted in any problems. The Group also believes that a requirement on the rotation of independent inspectors should be incorporated into the existing regulatory framework. *Sveriges Riksbank* believes that to the greatest extent possible efforts should be made to avoid the independent inspector and the external auditor coming from the same company. The Riksbank's reasoning for this is that investors must have confidence in the independent inspector and the work he/she carries out. *ASCB* has a few comments, for example that the words "*be able to demonstrate*" should be replaced with "*make it probable*".

Finansinspektionen's grounds:
Finansinspektionen stands by its opinion that the independent inspector should not undertake other assignments in the issuing institution or in other firms within the Group to which the issuing institution belongs.

In cases where external audits by the issuing institution are conducted by auditors from the same firm as the independent inspector, no conflicts of interest may occur. It is the independent inspector's responsibility to show that there are no conflicts of interest between the inspection and the external audit. The independent inspector can do this, for example, by presenting the procedures at the firm for these types of situations. It is not appropriate, as suggested by *ASCB*, to lower the requirement by switching out "*be able to demonstrate*" with "*make it probable* ".

With regard to the *Inspection Group's* comment that a requirement on the rotation of the independent inspectors should be implemented, Finansinspektionen believes that an assignment as an independent inspector in an institution shall last at the most seven consecutive years. The purpose of this is to further enhance the independence of the inspector. After a waiting period of two years, the independent inspector should be able to once again participate in the inspection of the same institution. This also applies to the firm this inspector represents. Finansinspektionen makes this assessment based on the proposed EU regulations[3] that prescribe the rotation of the traditional auditor in

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http://www.europarl.europa.eu/registre/docs_autres_institutions/commission_europeenne/com/2011/0779/COM_COM(2011)0779_EN.pdf

financial firms. When Finansinspektionen appoints independent inspectors, the authority will take into consideration the need to rotate independent inspectors. Given that which has been described above and that Finansinspektionen should not regulate its own actions in its regulations, Finansinspektionen will not introduce a rotation provision in the new regulations.

Inspector's assignments (Chapter 6, sections 2–4)

Finansinspektionen's position:
The current provision regarding the inspector's assignments are transferred in all material respects to the new regulations.

The independent inspector's assignments are extended to include the inspection of the revaluations of collateral conducted by the institution during the year.

The independent inspection shall be risk-based. The inspection of the value of the collateral, for example, shall focus on the geographic areas and types of collateral where the risk that the price may fall is judged to be particularly large and where the fall in prices has been largest. IT and system risks shall be reviewed more carefully after serious incidents or major system updates.

Consultation memorandum:
Contained more or less the same proposals.

Commentators:
ASCB proposes that the independent inspector should also analyse the results of the issuing institution's sensitivity analyses. The *Inspection Group* proposes that the provision in Chapter 6, section 4 be extended to include a more detailed description of risks. The Group would also like an inspection program to be prepared to support the inspector in his/her work. An inspection program would thus establish a minimum level for the inspection. It would also include a number of risk-based control issues that would guide the inspector.

Finansinspektionen's grounds:
There are grounds to regulate some of the circumstances around the independent inspector's assignments. Finansinspektionen's objective was to make the inspection more risk-based, which to a certain extent is achieved through the new regulations.

The independent inspector shall report on the issuing institution's sensitivity analyses in the annual inspection report. However, Finansinspektionen believes that it would be too much, as suggested by *ASCB*, to introduce a requirement that the independent inspector analyse the results of the issuing institution's sensitivity analyses.

Furthermore, it is not Finansinspektionen's opinion that there is currently a need for a more extensive description of risks in the regulations. Finansinspektionen also does not believe that it is appropriate to introduce an inspection program, which according to the *Inspection Group's* suggestion

Finansinspektionen's grounds:
As before, there is a need to clarify some of the circumstances surrounding the independent inspector's reporting obligation. It is appropriate for the annual report to also include a description of the revaluations of underlying collateral conducted by the issuing institution and a description of the issuing institution's sensitivity analyses of property that serves as collateral for mortgage loans in the register.

Like before, the independent inspector shall send a report of the inspection to Finansinspektionen on an annual basis. The inspector no longer needs to send a copy of the report to the auditor who is appointed by Finansinspektionen because such an auditor in general is no longer appointed.

With regard to the provision that the independent inspector, in addition to the annual report, shall inform Finansinspektionen about circumstances that are of significance for the authority's supervision of the institutions, Finansinspektionen has taken into account the feedback from the commentators and kept the provision. However, Finansinspektionen limits the information requirement to supervision related to covered bonds since this is the independent inspector's primary assignment.

With regard to the *Inspection Group's* questions regarding the purpose of the inspection plan, Finansinspektionen believes that it is most appropriate to discuss these questions in a dialogue with the independent inspector and the authority. Additional provisions regarding the inspection plan will therefore not be introduced into the regulations.

3 Consequences of the proposal

Covered bonds constitute a very large portion of the major banks' funding; of the market funding they represent roughly half of the borrowing. Even if the number of amendments is such that the old regulations are replaced by new regulations, the amendments as a whole are not considered to create large costs for the issuing institutions. Since covered bonds by nature are heavily regulated by laws and regulations, it is very important that the regulatory framework be as up-to-date as possible. An improved regulatory framework should be positive for Swedish credit institutions' continued funding via covered bonds. Finansinspektionen believes that the cost-related consequences of these regulations are small and even to some extent may result in lower funding costs for Swedish credit institutions. A lower funding cost for the issuing institution, then, could result in slightly lower interest rates for the bank's borrowers.

3.1 Consequences for the issuing institution

The amendments will clarify the requirements of the law and the independent inspector's assignments. They will probably entail that the work of the independent inspector is somewhat more time-intensive since his/her assignments are being extended. This in turn means a higher cost for the issuing institution in the form of higher remuneration to the independent inspectors.

Covered bonds represent a very large portion of the major banks' borrowing and investors' confidence in them is crucial for their demand. Increased supervision may therefore contribute to keeping borrowing costs in the industry down, which should benefit consumers. It is also important during times of financial uncertainty to maintain confidence in the system for covered bonds so that ambiguities in valuation, for example, do not lead to liquidity problems. An ineffective and weak regulatory framework that the market has no confidence in would be a risk for the entire Swedish financial system and thereby also the active financial institutions.

3.1.1 Affected institutions

There are currently seven institutions that have received authorisation from Finansinspektionen to issue covered bonds and thereby are affected by these amendments: Nordea, SEB, SHB, Swedbank, Landshypotek, SBAB and Länsförsäkringar.[4]

[4] In most cases, it is the mortgage companies (within these Groups) that have received authorisation to issue covered bonds. However, one exception is SEB which does not have a separate mortgage company. Another is Landshypotek, which does not have a subsidiary that issues bonds.

The independent inspectors will also be affected by the amendments. There are currently four independent inspectors.

3.1.2 Costs for the institutions

The change in the calculation of present value may result in some issuing institutions needing to make simpler changes to their systems or procedures. For example, it might be necessary to change an interest rate curve or an institution may need to obtain other interest rate curves for discounting. As a whole, it is Finansinspektionen's assessment that a change in the discount rate curve will not lead to significant costs for the institutions.

However, the institution's costs for remuneration to the independent inspectors will most likely increase since the amendments entail that the inspector, under the new regulations, will be given more extensive assignments.

The annual cost for the independent inspection may be around SEK 100,000-500,000 per institution. The extended requirements on the independent inspectors should increase costs by around 50 per cent. This estimate is based on the assumption that the independent inspectors are expected to increase the amount of time spent on the inspection by about 50 per cent as a result of the amendments to the regulations.

The cost of the inspector's work may vary considerably between institutions. If the inspection shows that an institution has deficiencies in its systems or its management of the operations, the cost may be higher, and vice versa. It can also be assumed that it is more expensive the first year an institution issues covered bonds since it takes time for an independent inspector to become familiar with the systems and procedures. This already applies today.

The amendments Finansinspektionen is making to the regulations regarding derivative counterparties may have consequences for institutions whose derivative counterparties will not fulfil the new credit rating requirements. Given that the current provisions are being clarified, institutions may need to find new counterparties with an approved credit rating. Of the major credit institutions that have a connection with Sweden, only a few currently do not fulfil the credit rating requirements for being counterparties in derivative agreements. Derivative agreements (currency and interest rate swaps) have become more expensive in recent years and the costs for the issuing institutions are therefore expected to be higher, perhaps millions of SEK annually. However, in the long run, finding a derivative counterparty with a better credit rating may result in lower funding costs since the bonds would be more secure. This cost savings is very difficult to estimate in advance.

The issuing institution shall conduct "sensitivity analyses", which entails both costs in the form of system upgrades to make it possible to conduct the analysis and personnel costs to conduct tests in the analysis. The institutions already conduct similar tests today for their internal governance, risk management and operational control. Therefore, the cost increase to meet the new requirements

on a sensitivity analysis may be assumed to be limited. For institutions that currently do not conduct sensitivity analyses but have access to the required data, the cost increase is estimated to be around SEK 100,000 per institution.[5] The ongoing cost is estimated to be around SEK 40,000 per year for an institution.[6]

The issuing institution's reporting will not affect the amendments to the regulations.

The provision regarding fire insurance is removed since Finansinspektionen does not consider fire insurance to be necessary in relation to the cost for monitoring it. This is a cost reduction for the institutions.

3.1.3 Consequences for small firms

No small firms currently issue covered bonds and therefore none are affected by the regulations. For firms that intend to become issuing institutions, the new regulations should not affect the barriers to entry to any significant extent.

3.1.4 Consequences for competition and the market

In the wake of the financial crisis, much of the market funding for a number of banks has been unstable. Confidence on some markets has still not recovered. Investors are more actively seeking safe assets than high yield assets than they did before the crisis. Covered bonds play an important role here since this market has proven itself to be resilient. Given that Sweden's national debt is currently low, there can be a need for relatively save assets denominated in SEK. The new regulations are judged to have a positive effect on the market, although the effect should not be over-exaggerated.

It is Finansinspektionen's opinion that the regulations will not have a significant effect on competition on the market. To be sure, the framework may be considered to benefit large institutions that have an organisation for issuing these bonds, but the new regulations do not enhance this benefit to any significant extent, and all of the affected institutions can be considered to be large financial market participants. The amendments should not benefit some institutions more than others. The amendments also do not significantly raise the barriers to entry for other institutions that would like to enter the market and issue covered bonds.

3.1.5 Consequences for society and consumers

One of the lessons learned from the financial crisis was that liquidity risks were underestimated. When confidence in some banks decreases on the market, solid banks also have a difficult time finding market funding. This course of events, where banks' borrowing costs rise sharply, can lead to large costs for society since banks play a central role in keeping society functioning efficiently.

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[5] The calculation is based on an hourly rate of SEK 500 and a total of 200 man-hours.

[6] The calculation is based on an hourly rate of SEK 500 and 80 hours of work.

The securitisation market, which according to many was a major cause of the crisis, basically died out during the crisis since became difficult to sell any new securitisations. Covered bonds are fundamentally different from securitisations in that the underlying collateral for bonds is not moved from the issuing institution's balance sheet. The bank therefore has a greater incentive in its role as an issuer of covered bonds (in contrast to securitisation) to ensure that the underlying collateral is of good quality. This may have been one of the reasons that the market for covered bonds withstood the crisis better than the securitisation market.

If the regulations function as intended, investors should be protected from losing the money they invested in covered bonds. The protection consists primarily of collateral for the mortgage loans included in the cover pool ("*loan-to-value requirements*"). There are also requirements from investors that the value of the cover pool should exceed the value of the covered bonds, i.e. "over collateralization". In addition to this, bond holders also have a claim against any bankruptcy estate in accordance with current bankruptcy regulations in the event that the cover pool does not cover the liabilities. These regulations aim to decrease the risk that investors will lose money. A well functioning regulatory framework for covered bonds, clear regulations for institutions and effective supervision make these securities more transparent and attractive for investors. In order to continue to maintain confidence in covered bonds, it is very important that the regulatory framework is effective and that market participants comply with its requirements.

In contrast to deposits, which can be another stable source of funding for banks, holders of covered bonds cannot expose the banks to *bank runs*. However, bank runs are unusual, to a large extent because of the deposit guarantee for deposited funds. This makes traditional deposits one of the funding sources that is least sensitive to disruptions to the financial system.

In contrast to short-term market funding, covered bonds normally have a maturity of several years. This means that the bank is not exposed to the same large liquidity risks that short-term market funding can have. Lower liquidity risk can result in more stable borrowing for firms, which benefits society in the form of financial stability. An effective regulatory framework for covered bonds maintains confidence in these securities and leads to financial stability, which from an economic perspective is positive.

Consumers will not be significantly affected by the new regulations. A good regulatory framework, however, leads to strong confidence for covered bonds on the market. This can, in the long run, lead to lower borrowing costs for banks, which in turn can lead to more inexpensive mortgages.

3.2 Consequences for Finansinspektionen

Since the independent inspector's duties will be somewhat extended, more resources will be needed from Finansinspektionen to follow up on the inspection reports and other observations made by the independent inspectors. If the independent inspector also has a considerable amount of ongoing contact with Finansinspektionen, this will require a certain amount of resources from the authority. In total, the estimated resources that will be needed are estimated to be a few hundred extra hours per year.

3.3 Commentators' feedback about the consequence analysis:

The *Regulation Board* supports the proposal but believes that the consequence analysis is deficient in that the estimation of the costs of the sensitivity analyses that the institutions must conduct has not included an amount.

Finansinspektionen asked the institutions to submit an estimate for these sensitivity analyses. No responses were received so Finansinspektionen made an estimation that was based on the assumption that the institutions are not already conducting stress tests.

The Association of Swedish Finance Houses declined from commenting on details in the proposal. However, the Association would like to call attention to the fact that even the funding needs of smaller firms should be taken into consideration, and the Association is therefore somewhat critical to the proposal, according to the Association itself, since it further raises barriers to entry (costs) for institutions that want to issue covered bonds. The Association states that this may further widen the divide that currently exists in Sweden between large banks and smaller institutions.

Finansinspektionen does not believe that the amendments in the new regulations significantly raise the barriers to entry or the costs for institutions that want to issue covered bonds. The purpose of covered bonds is that they are considered to be safe investments and investors have high levels of confidence in them. Given this background, the regulations for covered bonds place high demands on firms that want to issue them.