

Regulations and guidelines 6/2012

Mortgage bank authorisation procedure and risk management

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1 Scope of application and definitions

1.1 Scope of application

These regulations and guidelines apply to the following supervised entities as referred to in the Act on the Financial Supervisory Authority:

- mortgage banks as referred to in section 5 of the Act on Mortgage Credit Bank Operations (MCBOA)
- deposit banks and credit firms which have been granted authorisation by the Financial Supervisory Authority (FIN-FSA) to conduct mortgage bank operations as referred to in section 10 of the MCBOA.

1.2 Definitions

For the purpose of these regulations and guidelines, the terms listed below have the following meanings:

- *mortgage bank* is a credit institution as referred to in section 5 of the MCBOA (16.7.2010/688)
- *credit institution authorised to conduct mortgage bank operations* is a deposit bank or credit firm authorised by FIN-FSA to conduct mortgage bank operations according to section 10 of the MCBOA
- *supervised entity* refers to separate mortgage banks as well as to credit institutions authorised to conduct mortgage bank operations
- *collateral portfolio* refers to all mortgage loans, loans to the public sector, temporary collateral and hedges included in the aggregate portfolio amount.

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Legal framework and international recommendations

2.1 Legislation

These regulations and guidelines relate to the following statutes:

- Credit Institutions Act (CIA) (121/2007)
- Act on Mortgage Credit Bank Operations (MCBOA) (688/2010).

2.2 EU directives

These regulations and guidelines relate to the following EU directives:

- Directive 2006/48/EC (32006L0048) of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (Text with EEA relevance) (OJ L 177, 30.6.2006, p. 1–200).

2.3 FIN-FSA's regulatory powers

FIN-FSA's power to issue binding regulations on the topic in question is based on the following provisions in the MCBOA:

- section 10, subsection 3 (authorisation procedure)
- section 11, subsection 1 (risk management and internal control)
- section 16, subsection 4 (current value calculation)
- section 17, subsection 3 (liquidity requirements)
- section 18, subsection 3 (derivative contracts in mortgage bank operations).

3 Objectives

3.1 Objectives

- (1) The objective of these regulations and guidelines is to
- clearly and comprehensively present the authorisation application procedure and provide information on the principles of application assessment
 - steer the applicant's risk management and internal control through more detailed provisions on seniority and liquidation in order to also pay due attention to depositors' and other creditors' interests
 - provide mortgage banks and credit institutions authorised to conduct mortgage bank operations with codes of conduct as far as such guidance is not sufficiently included in the legislation.
- (2) The regulations and guidelines are necessary to protect both the public and holders of covered bonds against, among other things, the risk of losing repayable funds, and to supervise the reliability and stability of the banking system.

4 Authorisation procedure

4.1 Authorisation of a separate mortgage bank

- (1) A credit bank authorisation as referred to in section 24 of the CIA is required to establish a separate mortgage bank. More detailed provisions on the application for a credit bank authorisation are found in standard 1.1 on authorisations and notifications in FIN-FSA's set of regulations for the financial sector. The operations of a mortgage bank have been limited as provided in section 2, paragraph 6 of the MCBOA.

GUIDELINE (paragraph 2)

- (2) FIN-FSA takes the view that an application for mortgage bank authorisation should contain not only information as required for credit institution authorisation but also documentation according to section 10 of the MCBOA and section 4.2 below.

4.2 Application for authorisation of deposit bank and credit firm

- (3) According to section 10, subsection 1 of the MCBOA, FIN-FSA may on application grant a deposit bank or credit firm fulfilling the conditions in the said act authorisation to conduct mortgage bank operations.

GUIDELINE (paragraphs 4–19)

- (4) According to section 10, subsection 2 of the MCBOA, the applicant shall submit to FIN-FSA, in addition to its articles of association or rules for operations, such documentation as referred to in subsection 2, paragraphs 1–7:
- (5) 1) Documentation stating that the mortgage bank operations are conducted according to the relevant act and regulations issued thereunder (section 10, subsection 2, paragraph 1)
- (6) FIN-FSA takes the view that the description should comprise a single document that accurately shows how the operations are organised and how the limitations of the operations are taken into account.
- (7) 2) Business plan for the mortgage bank operations (section 10, subsection 2, paragraph 2)
- (8) FIN-FSA takes the view that the plan should be approved by the supervised entity's Board of Directors (Board) and that it should contain at least the information listed in section 5.3 below.
- (9) 3) Documentation of the applicant's financial position and capacity (section 10, subsection 2, paragraph 3)

- (10) FIN-FSA takes the view that the documentation should include, in addition to the financial statements, the interim report and periodic information submitted to FIN-FSA, documentation on circumstances known to the applicant that essentially affect its risk position.
- (11) 4) Documentation stating that the applicant has the expertise and professional skill required in mortgage bank operations (section 10, subsection 2, paragraph 4)
- (12) FIN-FSA takes the view that the documentation should contain information on managers in charge in such manner as referred to in FIN-FSA's standard 1.4 on assessment of fitness and propriety.
- (13) 5) Documentation showing that the applicant's risk management and control methods are at the required level for mortgage bank operations (section 10, subsection 2, paragraph 5)
- (14) FIN-FSA takes the view that the documentation should show how the applicant has organised the risk management in its mortgage bank operations as a single function so as to enable its transformation into an independent function in the event of liquidation.
- (15) FIN-FSA takes the view that the documentation should also contain an account of the internal reporting lines and responsible officers and the reporting to the Board as an integrated whole including model reports.
- (16) 6) Documentation on principles and practices in collateral valuation (section 10, subsection 2, paragraph 6)
- (17) FIN-FSA takes the view that the documentation should at least include the statistical method for monitoring the fair value of collateral, the decision-making in confirming the fair value and a description of the recording of values in the bank's systems.
- (18) 7) Documentation showing that the bond register fulfils the legal requirements (section 10, subsection 2, paragraph 7)
- (19) FIN-FSA takes the view that the documentation should contain an account of the technical solution of the register and of outsourcings, stand-by systems and auditability, according to FIN-FSA's regulations and guidelines 1/2012 on outsourcing, and of how the loans in the register have been separated from the rest of the lending.

4.3 Target matters in the application

GUIDELINE (paragraphs 20-21)

- (20) In its application, the supervised entity should focus on the following matters:
- How the supervised entity will continuously assess and check that the systems and practice ensuring seniority (section 25 of the MCBOA) do function and comply with the legislation.
 - How the supervised entity will assess and check that the mortgage bank operations can be transformed into an independent function in the event of liquidation.
 - The responsibilities of the different officers in the matrix organisation should be clearly defined and documented.

- The prudential control should be independent and separated from business operations. The information reported to the Board should originate from a unit separated from business operations.
- The business plan should be sufficiently detailed and may also contain limitations of operations.
- The market prices of the collateral should be followed up through statistical methods at appropriate intervals and the figures should be updated in the applicant's system without delay.
- The technical solution of the bond register should be reliable and should support existing systems, and FIN-FSA should be able to perform a technical inspection of the register.

(21) Before the application is submitted, the applicant should discuss, among other things, the following matters with FIN-FSA:

- circumstances affecting the applicant's financial position and the development thereof, in both the short and long term
- the applicant's funding position and funding objectives in both the short and long term
- circumstances affecting the applicant's risk position
- objectives and limitations in the business plan for mortgage bank operations
- limitations on maximum amounts for securities issues
- contents of the authorisation application
- bond register solutions.

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Risk management and internal control

5.1 Seniority

- (1) Section 25 of the MCBOA contains provisions on seniority of covered bonds and of liquidation and bankruptcy of the issuer.
- (2) According to section 11, subsection 1 of the MCBOA, FIN-FSA is empowered to issue regulations on risk management and internal control for mortgage bank operations.

REGULATION (paragraphs 3–5)

- (3) The Board of a credit institution authorised to conduct mortgage bank operations shall ensure that the seniority requirements are fulfilled at all times. It shall always be possible to determine other creditors' shares of the capital and interest flows as regards loans serving as collateral.
- (4) A credit institution authorised to conduct mortgage bank operations shall, on request and without delay, be able to provide FIN-FSA with an account of the implementation of seniority.
- (5) The Board of a credit institution authorised to conduct mortgage bank operations shall ensure that its mortgage bank operations can continue as legally required in the event of liquidation.

GUIDELINE (paragraph 6)

- (6) The bond register of a credit institution authorised to conduct mortgage bank operations should not include loans that are not included in the value of the collateral portfolio. Exceptions to this rule may include, for example, changes of collateral or restructuring of loans or other comparable events.

5.2 Limitations of operations

- (7) According to section 11, subsection 1 of the MCBOA, FIN-FSA is empowered to issue regulations on risk management and internal control for mortgage bank operations.
- (8) As regards limitations, the provisions in sections 49–50 of the MCBOA and in FIN-FSA's standards on credit institutions' risk management shall apply.

REGULATION (paragraph 9)

- (9) The Board of a credit institution authorised to conduct mortgage bank operations shall at least annually confirm and report limitations on operations to FIN-FSA, that is at least
- the allowed share of funding through covered bonds as compared to total funding and balance sheet total
 - the maximum amount of covered bonds in relation to the amount of available collateral.

GUIDELINE (paragraph 10)

- (10) In assessing the extent of limitations, a credit institution authorised to conduct mortgage bank operations should take the position of depositors and other creditors into account.

5.3 Business plan

GUIDELINE (paragraphs 11–12)

- (11) The Board of the supervised entity should at least annually confirm a business plan for the mortgage bank operations.
- (12) The plan should comprise at least the following:
- planned securities issues during the next year
 - objective and limitations for the allowed share of covered bonds as compared to total funding and balance sheet total
 - objective and limitations for covered bonds in relation to available collateral
 - pricing expectations, target credit rating level, target group, planned excess collateral, costs
 - quality and structure of collateral portfolio as well as sources
 - hedging principles
 - types of temporary collateral
 - use of structured securities issues
 - principles and goals for use of intermediary loans.

5.4 Requirements pertaining to market and liquidity risks

5.4.1 Market risk limitations

- (13) According to section 11, subsection 1 of the MCBOA, FIN-FSA is empowered to issue regulations on risk management and internal control for mortgage bank operations.

REGULATION (paragraph 14)

- (14) The supervised entity shall lay down limitations taking into account the provisions in chapter 6 of FIN-FSA's standard 4.4c on management of market risk.
- (15) FIN-FSA recommends that the supervised entity sets separate funding risk limits by, for example, fixing a maximum amount for covered bonds that may mature within a specified period.

5.4.2 Excess collateral requirements

GUIDELINE (paragraph 16)

- (16) If different excess collateral requirements have been set for different collateral pools, the supervised entity should separately monitor the excess collateral rates of different collateral pools.

5.4.3 Calculation of average maturity

- (17) According to section 17, subsection 1 of the MCBOA, a securities issuer shall see to it that the remaining average maturity of covered bonds does not exceed the remaining average maturity of the loans registered in the bond register as referred to in section 20.
- (18) According to section 17, subsection 3 of the MCBOA, FIN-FSA may issue more detailed regulations on the application of this paragraph.

REGULATION (paragraph 19)

- (19) The supervised entity shall calculate the average maturity as referred to in section 17, subsection 1 of the MCBOA as the average, weighted by the current values, of the remaining maturities pertaining to the remaining cash flows from the contracts. The current value shall be calculated by discounting the nominal value of the future cash flow to the present time. Derivatives shall be included in the calculation of the average maturities.

5.4.4 Accrued interest cash flows

- (20) According to section 17, subsection 2 of the MCBOA, the supervised entity shall further ensure that the aggregate interest accrued on the assets included in the aggregate collateral, during any period of 12 successive calendar months, is sufficient to cover the total amount of interest payable to holders of covered bonds and payments to counterparties in derivative contracts during the same period.
- (21) Before commencement of liquidation or bankruptcy proceedings of a mortgage bank or a debtor of an intermediary loan, the mortgage bank may, according to section 17, subsection 2 of the MCBOA, in respect of collateral granted by a debtor of an intermediary loan alternatively treat the interest payments on the intermediary loan as being the interest accrued on such collateral.
- (22) According to section 17, subsection 3 of the MCBOA, FIN-FSA may issue more detailed regulations on the application of this paragraph.

REGULATION (paragraphs 23–25)

- (23) Remaining cash inflows generated by capital, interest and derivative contracts pertaining to registered fixed and variable rate loans shall be calculated separately.
- (24) Remaining cash outflows generated by capital, interest and derivative contracts pertaining to issued fixed and variable rate covered bonds shall be calculated separately.
- (25) The future cash flows from variable rate contracts shall be evaluated using a method that has been documented in writing and approved by the Board of the supervised entity.

GUIDELINE (paragraphs 26–28)

- (26) The valuation of future interest cash flows from variable rate contracts may, for example, be based on the forward rate yield curve derived from the interest rate swap yield curve.
- (27) The total amount of interest receivable for any 12-month period should exceed the corresponding amount of interest payable also when a +/- 1 percentage point parallel shift is made to the yield curve used in the valuation of the contracts.
- (28) The yield curve for evaluating variable rate contracts should be raised or lowered (by, for example, a +/- 0.5 percentage point twist) and its effect on future cash flows calculated.

5.5 Requirements pertaining to mortgage loans and related collateral

5.5.1 Fair value of collateral

- (29) According to section 11, subsection 1 of the MCBOA, FIN-FSA is empowered to issue regulations on risk management and internal control for mortgage bank operations.

REGULATION (paragraphs 30–33)

- (30) The value of the collateral registered in the bond register shall be calculated on the basis of the fair value of the collateral for mortgage loans recorded in the systems of the supervised entity.
- (31) The supervised entity shall quarterly follow the development of the market values of the collateral for mortgage loans as provided in FIN-FSA's standards 4.3c, 4.3e and 4.3f, for example using the statistical method.
- (32) Application of the statistical method referred to in FIN-FSA's standards 4.3c, 4.3e and 4.3f requires that threshold values are set for price changes.
- (33) If the threshold value for a price drop is crossed, the supervised entity shall in its own systems without delay update the fair value of individual collateral as described in FIN-FSA's standards 4.3c, 4.3e and 4.3f.

5.5.2 Effects of value changes in the collateral portfolio

GUIDELINE (paragraphs 34–35)

- (34) The supervised entity should regularly assess the effects of value changes in collateral for mortgage loans and be sufficiently prepared for the consequences of the value changes due to falling market prices.
- (35) The supervised entity should apply stress tests for assessing the effects of value changes in the collateral portfolio. For the stress tests the supervised entity should separate the registered loans into different LTV (Loan-to-Value) categories. The test should show the number of loans by LTV category to be removed from the register according to section 14 of the MCBOA.

5.6 Requirements pertaining to management of operational risk

GUIDELINE (paragraphs 36–37)

- (36) The supervised entity should identify the operational risks related to mortgage bank operations and organise the management of operational risk according to the requirements pertaining to the characteristics of the mortgage bank operations and follow the provisions in FIN-FSA's standard 4.4b on management of operational risk.
- (37) The supervised entity shall ensure that the functioning and information security of the bond register are kept at such a level that the requirements in sections 20–22 of the MCBOA are fulfilled.

6 Repealed regulations and guidelines

- (1) When these regulations and guidelines enter into force, they repeal the provisions in chapter 8 on management of balance sheet risks in mortgage banks in FIN-FSA's standard 4.4c on management of market risk.

7 Reporting to FIN-FSA

- (1) The organising and contents of the supervised entity's regular reporting have been dealt with in FIN-FSA's regulations and guidelines 7/2012.