Legal Framework for Swedish Covered Bonds



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Introduction



What is a Swedish covered bond?

- Säkerställd obligation
- Full-recourse senior debt security
- Issued by a Swedish credit institution
- Backed by a cover pool of secure assets
- Priority for bondholders and derivative counterparties
- Designed to survive the insolvency of the issuer

Legislation-enabled regime

- Covered Bonds Issuance Act (in force since 2004)
- Supplemented by regulations of the Swedish FSA

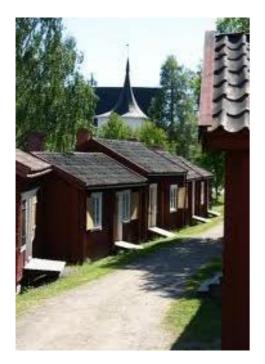
The cover pool



Eligible assets

- 1. Mortgage loans
- 2. Public sector loans
- 3. Substitute collateral

The cover pool – Mortgage loans



Criteria for mortgage loans in the cover pool

- Maximum loan-to-value ratios
 - 75% for residential collateral
 - 70% for agricultural collateral
 - 60% for commercial collateral
- Market valuation of collateral
 - generally: specific valuation by qualified valuer
 - residential collateral: valuation may be based on general price levels
- Maximum 10% commercial collateral in the cover pool
- Only collateral located in the European Economic Area

The cover pool – Other assets



Public sector loans

- Public borrower or guarantor, including:
 - The Swedish State
 - Swedish municipalities
 - The European Communities

Substitute collateral

- Cash and government bonds with zero-risk weighting
 - FSA may authorize use of certain other collateral
- Maximum 20% (temporarily up to 30%) of cover pool

Derivative contracts



- To hedge interest/currency risk and match cash flows
- Covered Bonds Issuance Act and FSA regulations prescribe:
 - eligible counterparties
 - minimum counterparty ratings
 - collateral posting requirements
 - disapplication of standard ISDA termination provisions

The cover register



- Issuer to keep an up-to-date register of *inter alia*:
 - cover pool assets
 - covered bonds
 - derivative contracts
- Registration is key:
 - only registered assets form part of the security in favour of bondholders and derivative counterparties
 - only registered covered bonds and derivative contracts benefit from such security
- Cover pool is dynamic, issuer may supplement and substitute assets (pre-bankruptcy)

Matching requirements



Three matching tests

- 1. <u>Nominal matching</u>: nominal value of cover pool to exceed nominal value of obligations
- 2. <u>NPV matching</u>: net present value of cover pool to exceed net present value of obligations (and withstand certain interest rate and currency exchange rate stress tests)
- 3. <u>Liquidity matching</u>: cash flows from cover pool and derivative contracts such that the issuer is able to meet obligations to bondholders and derivative counterparties
- Non-performing assets more than 60 days overdue are disregarded for the purposes of these tests
- No over-collateralisation prescribed by law (but permitted)

Supervision



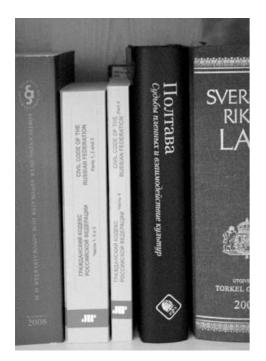
Before issuance

1. Specific FSA licence required to issue covered bonds

After issuance

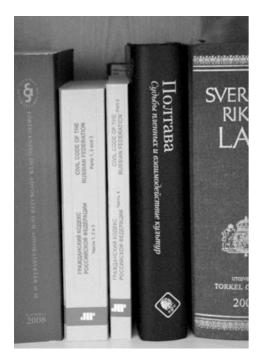
- 2. FSA supervises issuer and monitors compliance
 - sanctions include revocation of licence to issue covered bonds
- 3. FSA also appoints an independent inspector for each issuer
 - monitors cover register, valuations, matching etc.
 - reports to the FSA

Insolvency considerations – Security interest



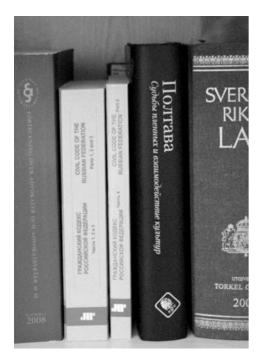
- Before and after issuer bankruptcy, covered bondholders and derivative counterparties benefit from security interest in:
 - cover pool assets
 - cash deriving from cover pool and derivative contracts
- Security interest ranks ahead of all unsecured creditors, including The National Tax Agency
- Bondholders and derivative counterparties rank *pari passu*
- Self-imposed over-collateralisation recognized and upheld

Insolvency considerations – Issuer bankruptcy



- EU Credit Institutions Winding Up Directive (2001/24/EC)
- Swedish Bankruptcy Act and Rights of Priority Act
- No consolidation in bankruptcy
- If issuer declared bankrupt, bankruptcy administrators appointed:
 - one (or more) by the bankruptcy court
 - one by the FSA
- No separate cover pool administrator

Insolvency considerations – Issuer bankruptcy



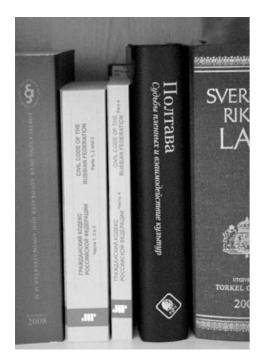
- So long as cover pool continues to meet matching and other legislative requirements:
 - cover pool, covered bonds, derivative contracts and cash are maintained as a unit and segregated from the general bankruptcy estate
 - continued timely payment on covered bonds and derivative contracts
 - → No suspension of payments, acceleration, early repayment or early termination

Insolvency considerations – Issuer bankruptcy



- If cover pool ceases to meet matching requirements and other legislative requirements (and not just temporarily):
 - enforcement of security by liquidation of cover pool
 - repayment of covered bonds
 - early termination of derivative contracts
- Covered bondholders and derivative counterparties also have ultimate recourse to assets of the general bankruptcy estate, *pari passu* with senior unsecured creditors

Insolvency considerations – Post-bankruptcy liquidity



- Covered Bonds Issuance Act amended in 2010 to improve access to liquidity post-bankruptcy
 - explicit mandate for bankruptcy administrators to enter into loan, repo, derivative and other transactions to maintain matching
 - to be used only if deemed to favour covered bondholders and derivative counterparties
 - new counterparties contract with the bankruptcy estate (not the issuer) and benefit from super-senior ranking
- Liquidity may also be raised by bankruptcy administrators selling cover pool assets

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