Realkreditrådet
ASSOCIATION OF
DANISH MORTGAGE BANKS

25 June 2013
jb

Internal Market and Services DG (DG MARKT)

Response submitted by:

Realkreditrådet (Association of Danish Mortgage Banks)

Interest Representative Registration ID number: 27545731905-17

Green Paper on Long-term Financing of the European Economy

The Association of Danish Mortgage Banks hereby gives its response to the public consultation on the Green Paper on long-term financing of the European economy. Our response is divided into two parts. First, we provide a profound overview of the Danish mortgage system. Second, we answer the relevant questions raised in the Green Paper. The two parts complement each other. The overview of the Danish mortgage system is fundamental and indispensable when reading the answers to the individual questions in the Green Paper.

Denmark has one of the world's best and cheapest mortgage systems providing long-term financing. The strict balance between loans and bonds and the market prepayment system is internationally unique. It has been robust during the financial crisis and subsequent periods of recession and low growth. The Danish mortgage model has contributed in a positive way to the Danish economy, and it has many of the characteristics required for long-term financing in the EU.

— — —

On page 2 of its Green Paper, the European Commission acknowledges that: "Looking beyond the financial crisis, an important question is whether Europe's historically heavy dependence on bank intermediation in financing long-term investment will give way to a more diversified system with significantly higher shares of direct capital market financing and greater involvement of institutional investors and alternative financial markets." Furthermore, it is acknowledged that: "The diminished role of banks in long-term lending opens up new needs and opportunities for other financial institutions and market-based intermediation to channel financing to long-term investments. However, the ability of institutional investors and markets to fill this gap depends on a number of conditions."

In Denmark more than 70% of total lending to businesses and households comes from the Danish mortgage banks, which are specialised non-deposit taking institutions effectively acting as mediators between borrowers and wholesale financial markets by solely relying on mortgage covered bonds (covered bonds) for funding. The loans are generally 30-year loans and thus long-term indeed. Below we offer a description of the Danish model of mortgage banking.

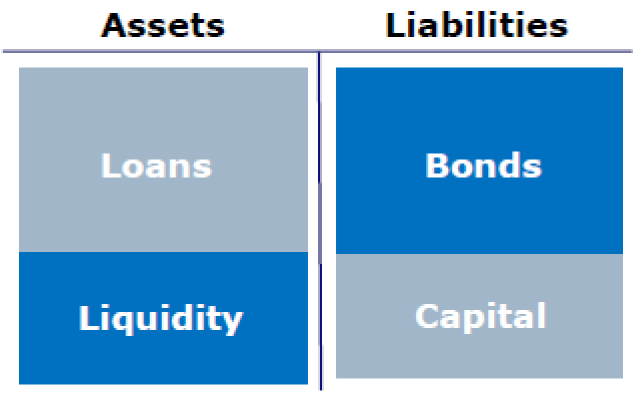
Zieglers Gaard
Nybrogade 12
DK-1203 Copenhagen
Tel: +45 33 12 48 11
www.rkr.dk
rr@rkr.dk

D56684

Overview of the Danish mortgage system

In Denmark mortgage loans are exclusively financed through the issuance of covered bonds. The Danish mortgage system is a pass-through system where payments on loans are passed through to bondholders. The Danish mortgage banks operate under a specialised model and do not take deposits, see Figure 1. A financing principle with a one-to-one match between the terms of the loans and the bonds, including the interest rate, is applied. The strict balance between loans and bonds contributes to transparency of products and prices when it comes to providing long-term financing. In Denmark, fixed-rate mortgages and ARMs are offered. Fixed-rate mortgages are financed with long-term bonds and are invulnerable to the problem of maturity mismatch, which the Green Paper explicitly mentions as an inappropriate source of volatility. ARMs are financed with short-term bonds even though the loan commitment is long-term, but the interest rate risk lies with the borrower. Under the Danish mortgage model, 30-year loans are most often used for long-term financing, and long-term financing requires long-term loan commitment. Even if the borrower has an adjustable interest rate, eg. an ARM with 1-year bonds backing the loan, the loan commitment is for 30 years and cannot be terminated by the lender. The borrower has the option to prepay the loan at any time and in addition to remortgage the loan. For instance, if he wants to fix the interest rate for a longer period of time, he can do so, or he can switch to a fixed-rate mortgage loan. Here it is important to note that there is no interest rate risk for the mortgage bank, and there have never been problems with refinancing. The interest rate at the time of refinancing is directly passed on to the borrower.[1]

Figure 1: The specialised mortgage bank

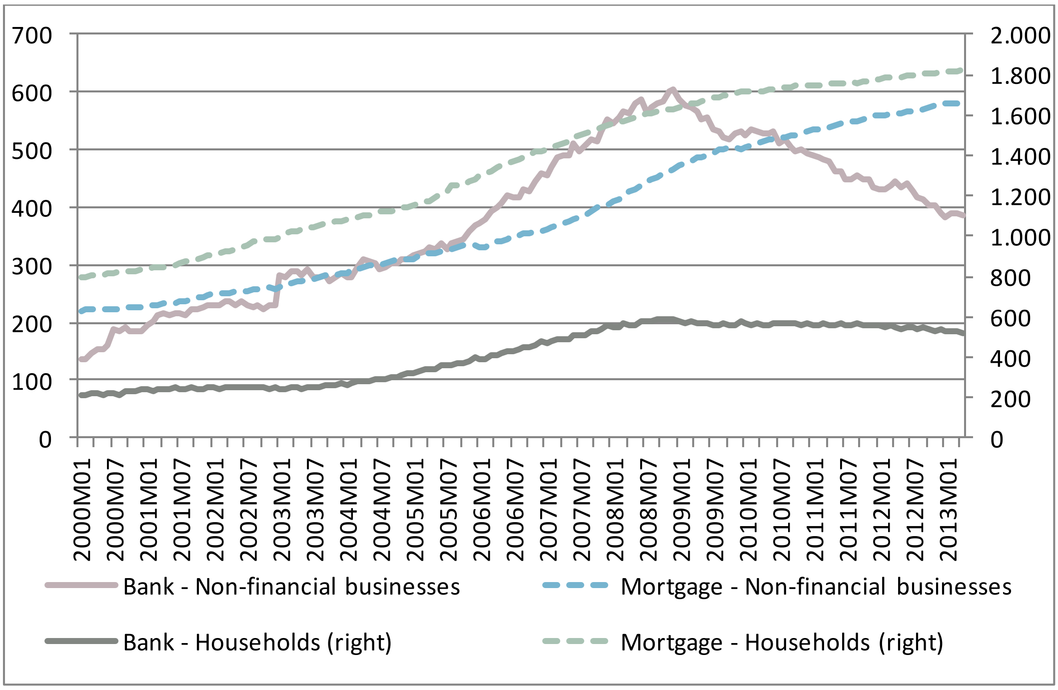


[1] Even a - in our view, of course – near-perfect model for long-term financing may be improved. As regards long-term fixed-rate loans, there is no criticism, but ARMs and LTV requirements are analysed by the Commission. Ref. (10.4.2013) SWD(2013) 115 final - In-depth review for DENMARK in accordance with Article 5 of Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances *Accompanying the document*

The outstanding bond debt was 2,466 billion in 4th quarter of 2012, corresponding to 135 per cent of Denmark's GDP. In other words, the Danish mortgage sector is a large part of the Danish economy and has contributed to stability in the Danish economy by offering long-term financing at low interest rates before, during and after the crisis.

The Danish mortgage model has been around for more than 200 years. Reviewed on developments since the financial crisis began, we believe that it will continue to exist. Danish mortgage banks were able to issue covered bonds without government support every day during the financial crisis to the benefit of households and businesses, which were able to achieve long-term financing secured on real estate. Furthermore, the system has proved a stable source of funding for Danish industry at a time when the supply of common bank lending has been in decline. Danish mortgage lending increased throughout the crisis, see the broken lines in Figure 2.

Figure 2: Mortgage lending and bank lending to non-financial businesses and households, DKKbn



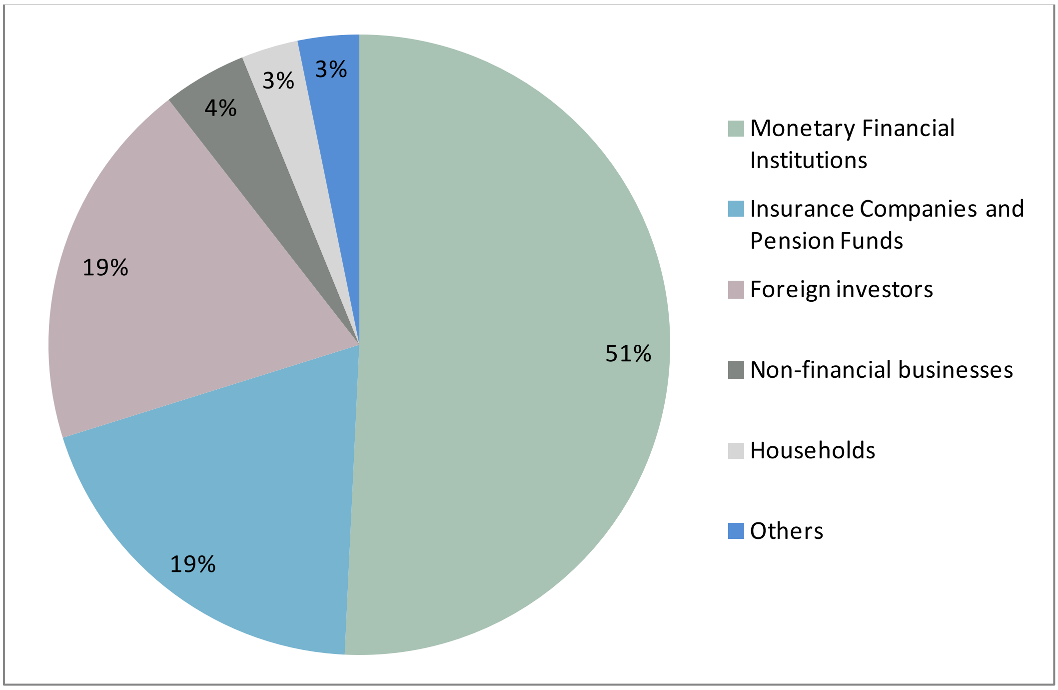
Source: Danmarks Nationalbank

A comprehensive analysis by Danmarks Nationalbank shows that in times of several banking and financial crises in Denmark, the real effects have been of minor importance. This is attributable to the strong market for mortgage loans in Denmark. During periods of limited lending capacity of banks, households and businesses have had the opportunity to meet their borrowing requirement through mortgages. This has contributed to stability in the Danish economy and limited the impact of financial crises on unemployment and other

social issues. In other words, the Danish mortgage system plays an important and stabilising role in the economy and society as a whole[2].

In Denmark, we have a stable mortgage system where it is possible to borrow money for long-term financing of housing and commercial properties at very low interest rates. The low interest rates largely reflect the confidence in the Danish mortgage market, which is perceived as a "safe haven" in a turbulent world. The Danish mortgage model and Danish covered bonds have gained wide acclaim abroad. There is great demand abroad for Danish covered bonds. The bonds are highly liquid and are considered a safe investment. Danish covered bonds are seen as attractive. This results in a robust mortgage system that provides long-term financing. Figure 3 shows the investor base of Danish covered bonds.

Figure 3: Investor base of Danish covered bonds



Source: Danmarks Nationalbank

In another analysis by Danmarks Nationalbank, it is concluded that Danish benchmark covered bonds are as liquid as Danish government bonds. Before the crisis, government bonds were slightly more liquid than covered bonds in both short- and long-term market segments. After the crisis, covered bonds have been as liquid as government bonds for short-term as well as long-term maturities[3].

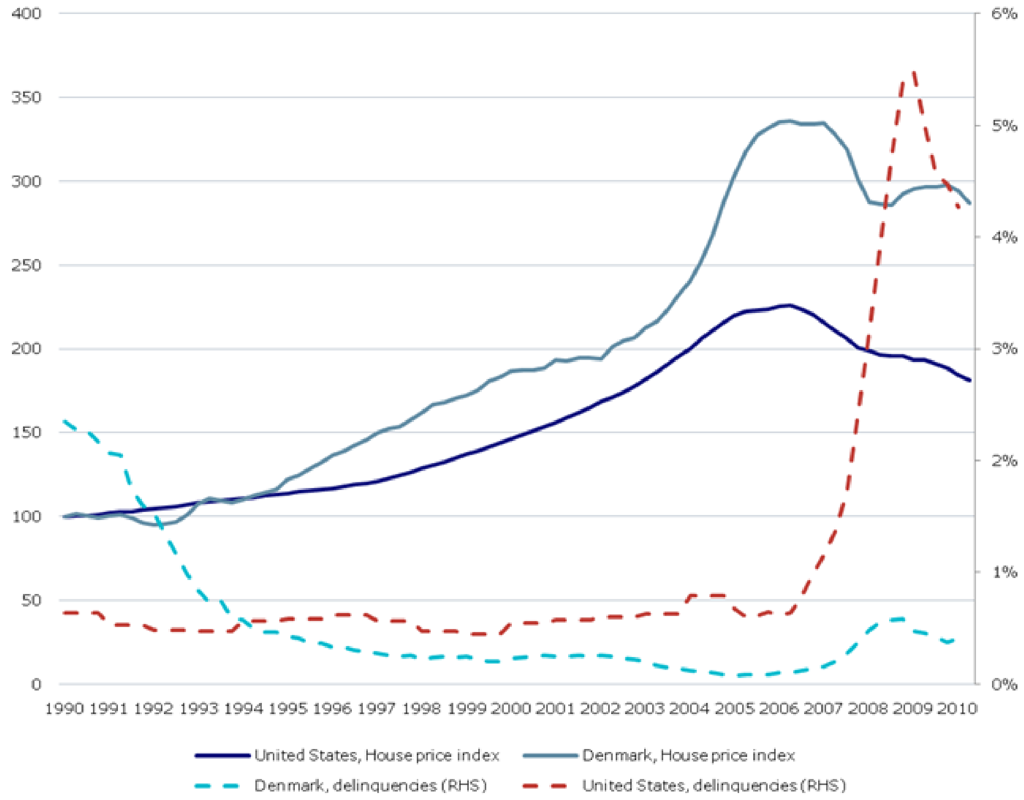
---

[2] Kim Abildgren - Danmarks Nationalbank, Working Papers 2012 • 78: "Financial Structures and The Real Effects of Credit-supply Shocks in Denmark 1922-2011"

[3] Buchholst et al. - Danmarks Nationalbank, Working Papers 2010 • 70: "Liquidity of Danish Government and Covered Bonds – Before, During and After the Financial Crisis"

In the Danish mortgage market, the prepayment risk is transferred to the investor. Whilst the loan commitment cannot be terminated by the lender, it is possible for the borrower to prepay, and for instance remortgage, the loan. This is an important fact since long-term financing requires long-term loan commitment. An analysis by HM Treasury, in which the Danish mortgage model is being praised for its long-term mortgage loans providing long-term financing, it is noted that there are uniform issues of callable covered bonds in Denmark, which are traded in a highly liquid secondary market where investors accept the prepayment risk. In addition, the management of credit risk is held at a minimum, where the spreads on covered bonds are low when the cost of the prepayment option is taken into account. The credit risk for mortgage institutions is constrained by strict lending rules, for example maximum LTV limits of 60-80 per cent[4]. Credit risk is contained through personal liability as opposed to the no-recourse loans that caused so many problems in the US. The result is that despite house price falls, delinquencies have represented a small fraction. In Figure 4 house price developments and delinquencies in Denmark and the US are compared.

Figure 4: House price developments and delinquencies in Denmark and the US



Source: Association of Danish Mortgage Banks, FHFA and Fannie Mae

———

[4] HM Treasury: "Housing finance Review: analysis and proposals", March 2008

Answers to relevant questions raised in the Green Paper

1) *Do you agree with the analysis above regarding the supply and characteristics of long-term financing?*

In Denmark, the outstanding bond debt of households and businesses is very large. This is shown by comparing with the outstanding debt of banks in Figure 2. We have a stable system where the supply of capital is effectively distributed on investment needs.

Using the Danish mortgage system, households and SMEs have the opportunity to access the credit markets via covered bonds and enjoy a low interest rate via capital markets.

6) *To what extent and how can institutional investors play a greater role in the changing landscape of long-term financing?*

As shown in Figure 3, a large part of Danish covered bonds are held by professional investors such as insurance companies and pension funds. The result is capital being channelled from institutional investors to borrowers, eg. households and SMEs. It is important not to impose regulation on investors that reduces their opportunities of investing in covered bonds. Today institutional investors such as insurance companies and pension funds hold almost 20% of the Danish covered bonds.

7) *How can prudential objectives and the desire to support long-term financing best be balanced in the design and implementation of the respective prudential rules for insurers, reinsurers and pension funds, such as IORPs?*

If one wants to raise long-term financing, otherwise than through the banking sector, capital must be channelled from institutional investors to households and SMEs. The prudential rules for investors such as insurers, reinsurers and pension funds must not be inappropriate but should rather contribute to the channelling of capital from suppliers to the sectors with long-term financing and investment needs.

This will also be addressed in question 10.

10) *Are there any cumulative impacts of current and planned prudential reforms on the level and cyclicality of aggregate long-term investment and how significant are they? How could any impact be best addressed?*

The Danish mortgage banks have been well-functioning for more than 200 years as mentioned in our general comments. Even in the midst of the financial crisis in 2008-09, Danish mortgage banks were able to fund new loans and refinance existing loans, while

the new covered bond markets in Europe were in severe difficulties. The financial strength is, of course, the combined result of prudent regulations on lending, the one-to-one match between loans and bonds and a high standing of covered bonds in an efficient bond market. There is an added effect from the flexible provisions on prepayment, which allow debtors, through refinancing, to reduce their interest payments when bond prices rise above par, and to reduce their outstanding debt when bond prices fall.

Unfortunately this positive picture can be effected in a negative way by the Basel-induced CRD requirements, especially by the new liquidity instruments in CRD IV/CRR. These instruments were conceived in Basel for international banks in order to reduce the liquidity risk involved in traditional banking which involves a controlled mismatch of assets and liabilities. Since the Commission wants to introduce uniform regulations for all European credit institutions, the Basel recommendations for big, international banks are now being forced upon specialised institutions in the EU, such as the Danish mortgage banks, which already have the necessary framework through restrictive national legislation.

<u>Examples of unsuitable interaction between different EU rules</u>

We have seen examples of unsuitable interaction between different draft EU rules. The final rules have not yet been determined, but we will point out some possible problems that we see. Such inconsistencies may be avoided or minimised. It concerns the treatment of covered bonds in CRR and Solvency II. In this respect, we address three issues:

i. <u>Financial Transaction Tax</u>

   A FTT of at least 0.1% on bond transactions is likely to affect bond sales in the markets affected. The FTT will have a direct, adverse impact on liquidity and pricing in the European bond market.

   An adverse liquidity effect contrasts with the new EU liquidity rules of the Capital Requirements Regulation (CRR), which are a response to the financial crisis. For instance, EU banks and mortgage lenders must have sufficient liquidity buffers to make them resilient to market turmoil. The short-term buffer (30-day rule) will have to be met with liquid or highly liquid bonds.

   Because of the adverse liquidity effect, a FTT on bond transactions may thus render it more difficult for European banks and mortgage lenders to comply with the new liquidity requirements, and liquidity management in general will become more difficult. This is hardly the aim of the new regulation and should be avoided by adjusting the proposal.

ii. Linking credit ratings to credit quality steps in CRD and Solvency II

In the Commission's consultation document from 2011 on the Level 2 implementing measures on Solvency II, a linking of credit ratings to credit quality steps was proposed. The proposed structure contained seven credit quality steps. EIOPA would be mapping credit ratings to credit quality steps.

The use of credit quality steps was already introduced in 2006 by the Capital Requirements Directive (CRD) governing credit institutions. The CRD applies six credit quality steps. National supervisory authorities determine which credit ratings are mapped to the individual credit quality steps. In the long term, EBA may become in charge of this process.

If rating-based credit quality steps are used in Solvency II, their use should be consistent with that of the CRD. That applies to both the number of credit quality steps, the mapping of credit ratings and the related capital requirements. Otherwise, the same securities will be treated very differently under the two regulatory frameworks.

iii. Dependence on third-party credit ratings

Generally any high dependence on third-party credit ratings and the sensitivity to rating changes are inappropriate. The regulatory framework should not contain pro-cyclical elements such as the use of credit ratings. Basically, the rules should be designed to ensure maximum stability and should therefore not be based on credit ratings.

For some market participants the use of internal rating models may be an alternative, although this would probably be limited to large financial institutions and large asset managers. Also transition periods – say a 6-month period – following rating changes triggering a regulatory response could be considered in some cases, as this may allow a more orderly unwinding of positions.

13) *What are the pros and cons of developing a more harmonised framework for covered bonds? What elements could compose this framework?*

The pros and cons of developing a more harmonised framework for covered bonds depend on the details of such harmonisation. The Danish mortgage model is characterised by:

- Low, competitive prices of loans against mortgages on real estate
- Transparency of prices and repayment terms for the loans
- Market-based pricing
- Availability to all owners of real estate
- Supports financial stability

The foundation of the Danish mortgage model that offers these unique qualities is the statutory framework of the system and the way in which the mortgage banks have chosen to carry out their lending activities within this framework. If significant changes are made to the foundation, we will no longer have a mortgage model with the mentioned unique qualities. From a Danish point of view, it is important to be able to keep the Danish mortgage system.

20) *To what extent do you consider that the use of fair value accounting principles has led to short-termism in investor behaviour? What alternatives or other ways to compensate for such effects could be suggested?*

Regarding the use of fair value accounting, we would underline that Danish mortgage loans are designated at fair value in accordance with IAS 39 9 (b)(i). To ensure accounting consistency between the liabilities (the bonds) that are fair-valued instruments and the assets (the non-traded loans), IAS 39 9(b)(i) and IAS 39 AG4E(d) give the option to designate non-traded financial instruments at fair value when doing so reduces measurement inconsistency. Accordingly, the purpose of the fair value designation of Danish mortgage loans is to ensure that no accounting mismatches are created between assets and liabilities, which would otherwise arise when using amortised cost measurement of the loans. Danish mortgage banks' use of fair value accounting has nothing to do with short-termism in investor behaviour.

———

To sum up, we think the EU should make use of the opportunity to build on the unique European instrument of covered bonds to create a financial system in Europe that will provide long-term financing and share the best features of the best systems. A system that will secure continued access to long-term finance for all citizens and businesses in Europe, even when a financial hurricane is raging.

We are of course available, should you want further clarification of the Association of Danish Mortgage Bank's response to the Green Paper on long-term financing of the European economy.

Sincerely yours,

Jens Valdemar Krenchel

Head of the Brussels Office

D56684