Realkreditrådet
ASSOCIATION OF DANISH MORTGAGE BANKS

REALKREDIT FORENINGEN

24. June 2013

To: The European Banking Authority
by email: EBA-CP-2013-05@eba.europa.eu

Joint answer submitted by:

Realkreditforeningen (Danish Mortgage Banks' Federation) and Realkreditrådet (Association of Danish Mortgage Banks)

**EBA Consultation Paper on Draft Implementing Standards on Asset Encumbrance Reporting under article 95a of the draft Capital Requirements Regulation (CRR)**

Dear Sir or Madam,

The Danish Mortgage Banks' Federation and The Association of Danish Mortgage Banks appreciates the opportunity to comment on the draft RTS on Asset Encumbrance Reporting. We consider the consultation paper an important contribution to the ongoing discussion on asset encumbrance.

## General remarks

The draft RTS sets out reporting standards for asset encumbrance for European credit institutions, cf. article 95a of the CRR.

However, future references to the concept of asset encumbrance – e.g. EBA guidelines according to article 428a and the LCR liquidity definition according to article 404(3) – will inevitably spill over to the definition being established now.

In the explanatory remarks for this consultation, it is stressed that the definition is NOT based on an explicit legal definition, but rather on economic principles. It is therefore important that the definition will be sufficiently robust and nuanced reflecting the actual material consequences of asset encumbrance in specific arrangements.

As an example, if the asset encumbrance definition as proposed in the CP is to be interpreted in the strictest sense, Danish mortgage banks will by their very design have an asset encumbrance ratio of virtually 100 percent since covered bonds are the only legal funding instrument for lending in those institutions – no deposits may be taken. Assets in cover pools make up the entire balance sheet of Danish mortgage banks.

Such ‘full asset encumbrance’ could have extreme and unintended consequences if all assets – including in all other ways LCR-compliant liquid assets – were to be considered encumbered under all material circumstances. Thus, non-compliance with the LCR would be guaranteed.

This would in no way reflect actual liquidity. The ‘encumbered’ assets are not tied up in any absolute sense, nor are they unavailable for their intended purposes. In fact they are fully available to cover the relevant liquidity outflows, e.g. payments to the covered bond holders.

In other words, there is no encumbrance “in the wrong direction”. The liquid assets in the cover pools are thus not encumbered in a material way that prevent them for being liquidated (e.g. by being used as collateral in a repo) and – though being in a covered bond cover pool – do not lead to any structural subordination of simple depositors.

Since Danish mortgage banks are non-deposit taking institutions, reporting on asset encumbrance due to covered bonds issuance doesn’t seem relevant[1]. If anything, this should be considered encumbrance “in the right direction”.

Therefore we favor an asset encumbrance definition that distinguishes between the “degree” of asset encumbrance depending on the actual systemic risk (essentially no depositors), awareness of structural subordination by other professional senior creditors (“consenting adults”) and material consequence (availability for other transactions). This is also in line with the general recommendations from ESRB[2].

For instance a definition

- that rules out specific types of non-deposit taking institutions, or
- that takes into account the degree of senior secured and unsecured creditors (bondholders or other professional investors) clearly informed of their position in a gone concern situation (i.e. no guarantee or “bail out”), or
- that at least takes due account of arrangements where encumbered assets may be material available (i.e. essential not encumbered) for other transactions.

This will be in the spirit of the CRR which explicitly states that the European business model diversity should be carefully respected.

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[1] The Danish central bank doesn’t find the concept of asset encumbrance relevant for Danish mortgage banks since these institutions are specialized financial institutions only allowed to make mortgage lending funded by covered bonds, i.e. not allowed to receive deposits. For more information, please cf. “The Financial Stability Report 2013”, Danmarks Nationalbank, http://www.nationalbanken.dk/DNUK/Publications.nsf/side/Financial_Stability_2013/$file/fs_2013_recommendations_and_assessment.pdf

[2] The European Systemic Risk Board states that though asset encumbrance shifts risk among creditors (structural subordination) the extent to which risk-shifting is a risk for unsecured creditors depends on their capacity to price that risk (ESRB recommendations on funding of credit institutions, ESRB/2012/2).

**Responses to specific questions**

*Q1: Is the definition of asset encumbrance sufficiently clear?*

We do not find the definition sufficient clear as it does not take into account that asset encumbrance does not have a uniform material consequence and that the risk of asset encumbrance depends on the specific business model, i.e. funding structure and terms and conditions for specific creditors.

Instead as noted above, we propose a definition that distinguishes between the “degree” of asset encumbrance (changes are marked by underlining – proposals could be combined):

“*For the purpose of the regulation an asset is considered encumbered if it has been pledged or if it is subject to any form of arrangement to secure, collateralize or credit enhance any transaction from which it cannot be freely withdrawn.*

*<u>Assets used to secure, collateralize or credit enhance covered bonds issuance in non-deposit taking specialized mortgage banks are as such not considered encumbered.</u>*

or

*<u>Assets used to secure, collateralize or credit enhance any transactions only funded by professional senior creditors (both secured and unsecured) clearly informed of their non-guaranteed position in a gone concern situation are as such not considered encumbered</u>.*

or

*<u>Assets used to secure, collateralize or credit enhance specific given transactions, however available for other transactions under the arrangement are as such not considered encumbered.</u>*

*Q3: Do you believe the chosen definition of asset encumbrance ratio is appropriate? If not, would you prefer a measure that is based solely on on-balance sheet activities (collateral received and re-used, for instance from derivatives transactions would not be included) or a liability?*

From the point of view of the senior unsecured creditor, it is most important to know which assets will cover his claim in case of a gone concern situation. Thus the most appropriate indicator is the ratio of unencumbered assets to unsecured liabilities which is more directly relevant to unsecured creditors worried about getting paid back in the event of default.

Cf. the discussion above, professional senior creditors clearly informed by their position in a gone concern situation are probably interested in transparent information about the specific assets when assessing their request of return on their investment.

*Q4: Do you agree with the thresholds of respectively 30 bn. € in total assets or material asset encumbrance as defined as 5% of on- and off-balance sheet assets encumbered? If not, why are the levels not appropriate and what would be an appropriate level? Should additional proportionality criteria be introduced for the smallest institutions?*

We think that the absolute thresholds are appropriate. We do, however depending on the final definition, propose another proportionality criteria: A proportionality criteria for non-deposit taking financial institutions where all senior creditors are professional investors (e.g. bondholders) clearly informed of their position in a gone concern situation. Cf. the discussion above, for such institutions encumbrance is transparent and "in the right direction". Hence, there is no need for asset encumbrance reporting, or the reporting should at least distinguish between asset encumbrance in such institutions compared to other institutions.

*Remaining questions:*

We do not have further comments.

Yours sincerely

| Realkreditforeningen | Realkreditrådet |
|---|---|
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## Appendix

### Structure of Danish covered bonds

The tradition of financing residential and other property through specialised mortgage banks issuing mortgage covered bonds goes back more than 200 years in Denmark. Danish covered bonds may be issued either by mortgage banks (specialised banks offering loans funded by covered bonds) or through segregated cover pools on the balance sheets of banks.

With a volume of EUR 345bn outstanding mortgage covered bonds, the Danish mortgage covered bond market is the second largest mortgage covered bond market in Europe. Danish mortgage banks are subject to special legislation and represent about 95% of the total Danish covered bond market.

Current Danish mortgage legislation aims to ensure that issued covered bonds are highly secure. To this end, the legislation prescribes continuous LTV (loan-to-value) compliance, with an 80% LTV limit for private residential housing and a 60% LTV limit for commercial properties. Further, the issuance of covered bonds in Denmark is subject to the balance principle. The balance principle ensures that an issuer assumes no significant risks, such as interest rate risk, liquidity risk or currency risk, other than credit risk in respect of its customers. Finally, issuance is subject to a match funding principle, according to which the payments on covered bonds sold fully match the interest payments received from borrowers.

The issued loans remain on the balance sheets of the mortgage banks until maturity, and the greatest risk assumed by a mortgage bank is credit risk in respect of borrowers. Mortgage banks issue covered bonds out of capital centres (cover pools). The cover pools are on the balance sheets of the mortgage banks and consequently subject to financial legislation and control. Banks issue covered bonds out of registers that are very similar to capital centres and subject to very similar legislative treatment.

Mortgage banks obtain funding by issuing bonds registered in a central securities depository. The assets of a cover pool include the issued loans as well as highly secure securities, and the liabilities include the issued securities and equity.

The Danish mortgage system has operated smoothly for 200 years, and no issuer has ever gone bankrupt. Loan losses have amounted to less than 1% of lending – even during the Great Depression in the 1930s. During the recent financial crisis, losses including commercial properties amounted to about 0.2% pa of total lending.

Throughout the financial crisis, Danish covered bonds were traded in larger volumes than sovereign debt, and Danish mortgage banks remained able to fund loans by issuing covered bonds without any need for government purchases or government guarantees of the bonds.

*Key points on regulation and security*
Mortgage banks are subject to supervision by the Danish Financial Supervisory Authority (FSA), and they must have a licence to carry on mortgage lending. To obtain such licence, mortgage banks must comply with a wide range of requirements based on the CRD requirements applying to credit institutions.

Balance sheets of Danish mortgage banks are structured with a number of separate capital centres (cover pools) out of which covered bonds are issued. A capital centre consists of a group of series in which covered bonds backed by an equivalent amount of mortgage loans (match funding) are issued and a joint series reserve fund (equity). In addition, supplementary capital (senior secured debt/junior covered bonds) may be issued out of the capital centre for overcollateralization purposes.

Loans issued out of a capital centre are secured by mortgage on real property. In addition to this security, borrowers are fully and personally liable for the loans, and loan commitments are up to 30 years. As a result, any credit loss will be covered by the borrowers over time. This calls for orderly and prolonged resolution of an insolvent mortgage bank in order to protect covered bond investors.

Most mortgage banks have several capital centres on their balance sheets. The capital adequacy requirement laid down in Danish legislation must be complied with by the mortgage bank as a whole, but also by the individual capital centre. If a capital centre ceases to meet the statutory capital adequacy requirement, the mortgage bank must provide supplementary capital to the capital centre in order to restore compliance unless such provision would cause the mortgage bank to become non-compliant in terms of capital adequacy.

If a mortgage bank is declared bankrupt, a trustee in bankruptcy is appointed. The trustee looks after the interests of the estate in bankruptcy, i.e. the interests of the creditors and particularly the covered bond investors in relation to the individual capital centres. The trustee must seek the most efficient administration of the estate, having regard to the fact that the position of covered bond investors and borrowers must remain essentially as if the capital centre had still been a going concern. If a mortgage bank is declared bankrupt, no acceleration therefore takes place in respect of covered bond investors or borrowers. The investors risk is in case of bankruptcy on the portfolio of borrowers in the particular capital centre, which is inherently a well diversified portfolio in itself. This is the key principle. It is only possible because the mortgage system is structured around capital centres that offer very high statutory collateral for bonds based on ring-fenced, bankruptcy-remote capital centres and match-funded lending. This characteristic also reduces the wrong way risk that could occur when issuers post their own bonds or when Danish investors post Danish covered bonds as collateral.

Resolution is not fast, but orderly, with a minimum of changes for both bond investors and borrowers. No public funds are used for such resolution, as borrowers' ongoing payments are passed through to bondholders. Holders of hybrid core capital and subordinate loan capital cannot use the bankruptcy of a mortgage bank as grounds for a claim of default. Similar rules apply to counterparties to financial instruments used to hedge risk in a capital centre.

The Danish system ensures a very high degree of security for both bond investors and borrowers, as their position will be affected not by the bankruptcy of a mortgage bank but only by ordinary market changes

*The market for Danish covered bonds*

The Danish covered bond market is very sophisticated with several product types ranging from short term (1 to 10Y) non-callable fixed rate bullets to long term (10Y to 30Y) callable fixed rate annuities. More than 90% is DKK-denominated and the rest is primarily EUR-denominated. The investor base consists primarily of large professional investors (financial institutions or life and pension funds) – typically 15% is held by foreign investors. Danish covered bonds are the preferred liquidity instrument of Danish credit institutions which typically holds 50% of the issued covered bonds.

Danish covered bonds are typically registered in Copenhagen (VP SECURITIES) or in Luxembourg (EUR-denominated registered at VP LUX) and listed at NASDAQ OMX Copenhagen. All registered bonds are repo-eligible in the Danish central bank and bonds registered in Luxembourg are also repo-eligible in the euro money system. The 100 largest bonds series (ISINs) amount to approximately 2/3 of the total outstanding volume of Danish covered bonds and are traded frequently. All transactions (including OTC) are reported to NASDAQ OMX Copenhagen and published immediately making the market very transparent[3].

The specialised mortgage banks are contributing to the trading activity themselves selling daily tap-issuances or making buy-backs aligned with the mortgage (re-mortgage) lending or refinancing activity. In the past 5-7 years average daily turnover has varied around EUR 2-3bn with spikes up to EUR 13bn in months with refinancing activities. Thus especially the high volume bond series are very liquid.

Danish mortgage lending and refinancing activity, and average daily turnover of the Danish covered bonds continued largely unaffected even during worst days of the financial crises in 2008. Spreads to government bonds increased but unlike most other European covered bond markets trading did never halt and issuers and investors kept being active in the mar-

[3] For a more comprehensive description of the Danish covered bond market, please refer to http://www.nykredit.com/investorcom/ressourcer/dokumenter/pdf/Danish_covered_bond_web.pdf. Nykredit Realkredit is the largest Danish covered bonds issuer.

ket throughout the days and months after the Lehmann collapse unlike most other financial markets in the world. Observed traded bid-ask spreads widened during the peak of the crises in 2008, but not to a larger extend than traded bid-ask spreads on Danish government bonds. This has been documented by studies made by the Danish central bank[4,5].

Finally, Danish covered bonds are highly likely to qualify as transferable assets of extremely high liquidity and credit quality (level 1 assets) in the EU implementation of the Basel III liquidity framework (Liquidity Covered Ratio). The proposal for a regulation[6] permits the recognition of covered bonds under level 1 assets provided they satisfy a number of criteria in terms of liquidity and credit quality. These liquidity criteria are to be defined further by the European Banking Authority in 2013.

The highly transparent Danish covered bond market – and thus access to valid transaction data – makes it very likely that Danish covered bonds will satisfy the criteria for recognition as level 1 assets.

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[4] Buchholst, B.V, J. Gyntelberg and T. Sangill (2010): "*Liquidity of Danish Government and Covered Bonds – Before, During and After the Financial Crisis – Preliminary Findings*", Danmarks Nationalbank Working Paper Series, no. 70 (2010).
http://www.nationalbanken.dk/DNUK/Publications.nsf/8b8fe2a60c3a10cbc1256be50057a78e/7a25ccdafbfe3012c12577ae004f4584!OpenDocument

[5] Dick-Nielsen, J., J. Gyntelberg and T. Sangill (2012): "*Liquidity of Danish Government versus Covered Bonds Markets*", Danmarks Nationalbank Working Paper Series, no. 83 (2012).
http://www.nationalbanken.dk/DNDK/Publikationer.nsf/side/WP_832012_Liquidity_in_Government_versus_Covered_Bond_Markets!OpenDocument

[6] Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on prudential requirements for credit institutions and investment firms, EU Commission July 2011.
http://ec.europa.eu/internal_market/bank/regcapital/new_proposals_en.htm