FINANSRÅDET

DANISH BANKERS ASSOCIATION

The Basel Committee on Banking Supervision
Bank for International Settlements,
CH-4002 Basel,
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Strengthening the resilience of the banking sector

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The Danish Bankers' Association, Finansrådet, welcomes the work of the Basel Committee of putting the ideas of notably the Financial Stability Board (FSB) and G20 into practice. We would like to thank the Basel Committee for the opportunity to comment on the proposed initiatives to strengthen the financial regulation and we find that the issues involved are of fundamental importance. Should the Basel Committee wish to engage in dialogue about the issues that we raise in the paper, please do not hesitate to contact us.

In light of all the new and very important regulatory initiatives, we find it important to underline that the various new initiatives need to be fully analysed and not only partially analysed to avoid the risk that the initiatives will prove counterproductive, because they involve double counting or mutually conflicting solutions. Also, we find that a principle of proportionality should be integrated in the initiatives, so that small and medium-sized banks can fulfil the standards.

The Danish Bankers' Association believes that some aspects of the proposal will have a severely negative impact on financial stability in Denmark, certain sectors of the Danish economy and consumers. This concerns predominantly the consequences for the Danish mortgage system.

The implementation of a too simplistic leverage ratio and the introduction of new liquidity regulations[1] as suggested by the Basel Committee will significantly impair the ability and willingness of banks to engage in mortgage transactions. In addition to increased transaction costs, such measures will have significant negative implications for the mortgage bond market and thus the ability of mortgage credit institutions to grant loans and for the costs consumers have to bear.

In addition, the Danish Bankers' Association would like to comment on the new capital definition. Although we do acknowledge that the target group

[1] It is highly relevant to look at the various regulatory initiatives combined. For our comments on liquidity management, please refer to the separate response from the Danish Bankers' Association regarding the Basel Committee's International framework for liquidity risk measurement, standards and monitoring. This response also represents a Danish angle.

for the Basel Committee's framework is large banks, we find that the new capital definition should be applicable to small banks as well, especially Danish savings banks. We have therefore added a comment on this and we urge the Basel Committee to consider it.

We would like to underline that we fully support the EBF position paper regarding the Basel Committee's "Strengthening the resilience of the banking sector" document. We would like in particular to stress our support for the EBF position regarding the initiatives to minimise procyclicality. This paper ends with a brief comment on the implications of these initiatives for the implementation process.

Furthermore we fully support the suggestions by both the Association of Danish Mortgage Banks/the Danish Mortgage Banks´ federation and the Danish Financial Supervisory Authorities/the Danish Central Bank to find feasible solutions to the problems raised in their responses. There is common ground that the consequences for the Danish financial system and macro economy are severe and we strongly urge the Basel Committee to engage in a dialogue with us and the other Danish stakeholders to adjust the regulatory initiatives accordingly.

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The impact on the Danish Mortgage System

The negative impact on the Danish Mortgage System is a result of:

- The unique structure of the Danish Mortgage System
- Denmark being a small open economy with its own currency

The mortgage credit market is by far the dominant supplier of financing of real property in Denmark, and the Danish mortgage credit market is the largest in the world in terms of GDP and the second-largest in Europe in absolute terms, exceeded only by the German pfandbrief market. The current (end-2009) outstanding amounts of Danish covered bonds are EUR 366 billion (primarily denominated in local currency). In comparison, the current size of the Danish government bond market is EUR 88 billion, which means that the size of the Danish government bond market is only 1/4 of the Danish covered bond market.

Danish mortgage credit finance is supported by a restrictive and detailed regulatory framework designed to protect mortgage bond investors. Key elements of the regulatory framework are:

- mortgage credit institutions must operate subject to the balance principle, which limits the liquidity and market risks of mortgage credit institutions to an absolute minimum. This is done by prefunding the mortgage loans with matching mortgage bonds.
- mortgage credit institutions must operate subject to a specialist bank principle, which confines the activities of the institutions to mortgage lending based on the issuance of mortgage bonds.
- mortgage loans and securities serving as collateral must meet restrictive eligibility criteria, including loan-to-value limits and valuation of property requirements.
- mortgage bond investors have a privileged position in case of bankruptcy, which renders mortgage bonds bankruptcy–remote.
- mortgage credit institutions are supervised by the Danish FSA.

Mortgage bond investors are further protected by the Danish title number system and the land registration system as well as efficient compulsory sale procedures.

The balance principle

The balance principle is a guiding principle of Danish mortgage credit finance, which restrictively regulates the market risk of mortgage credit institutions. The principle imposes a number of restrictions on the risks mortgage credit institutions can take. The limits applying to interest, currency and prepayment risks are very strict and regulated in the balance principle.

Mortgage loans are pre-funded. This implies that the mortgage credit institution issues the underlying bonds in the market prior to disbursement of the proceeds to the borrower. The price of the bonds sold in the market is

reflected in the net proceeds to the borrower, who thus carries the funding risk and assumes the interest rate risk. This is due to the pricing of the mortgage loans being based on the coupon of the bonds, to which the mortgage credit institutions add an administration margin.

The principle of callable loans ensures that the risk of borrowers calling their loan at par is fully passed on to the bond investors. Employing this principle means that mortgage credit institutions remain unaffected by borrowers' calling the loan at par. This is because the prepayment risk on the mortgage loans is embedded in the terms and conditions of the bonds funding the mortgage loans and is thus borne by the bondholders.

The balance principle is a key element in ensuring that the mortgage finance system for the mortgage credit institutions have practically no market, liquidity or pre-payment risk.

The credit risk is fully supported by the capital and reserves of the individual mortgage credit institution. The strict lending criteria and specialist banking structure allow higher balance sheet gearing than in universal banking and have resulted in historically very moderate credit losses.

This has resulted in a stable and very secure mortgage finance system that has proven its resilience during periods of financial stress – most recently throughout the financial crisis in 2008 and 2009, when the issuance of mortgage bonds and the liquidity in the market was maintained, as was the mortgage credit institutions' ability to grant new loans to consumers. Since the establishment of the Danish mortgage finance system in the late 18^{th} century, bond investors have not experienced any losses on their holdings of Danish mortgage bonds.

The stability of the mortgage bond market is supported by the fact that mortgage bonds:

- are considered a safe investment by investors
- are supported by a large and liquid market
- have a large domestic and international investor base

The banking sector plays an important role in the mortgage bond market that is essential to the resilience of the mortgage finance system. This is based on banks' ability and willingness to:

- trade in and create a liquid market for mortgage bonds
- hold mortgage bonds in their portfolios
- engage in repos based on mortgage bonds
- engage in hedging transactions with investors relating to currency and interest rate risks on mortgage bonds

These activities contribute to the banks' balance sheet and off–balance-sheet positions – but do not entail any significant risks.

The participation of the banking sector in this business ensures an efficient mortgage bond market with low transaction costs. The implementation of a too simplistic leverage ratio and the introduction of new liquidity regulations as suggested by the Basel Committee will significantly impair the ability and willingness of banks to engage in these transactions. In addition to increased transaction costs, such measures will have significant negative implications for the mortgage bond market and thus the ability of mortgage credit institutions to grant loans and for the costs consumers have to bear.

Given the secure nature of the mortgage bonds and the size and liquidity of the market, mortgage bonds are widely used as a liquidity buffer for liquidity management purposes by banks in Denmark. The Danish banking sector currently (end-2009) holds approximately EUR 156 billion in domestic mortgage bonds compared to EUR 11 billion in government bonds. Danish mortgage bonds have been eligible for repo transactions with the Danish central bank since the establishment of the current monetary policy framework in the early 1990's.

In summary, several of the Basel Committee's proposals will – if implemented as drafted – pose significant challenges to the Danish mortgage finance system and the prerequisites for the operation and resilience of the system – and thus financial stability in Denmark.

Allow us the observation that it would be ironic if the regulations intended to prevent a financial crisis were to disrupt possibly the only mortgage finance market which continued to work through the financial crisis and which had no part in creating losses for investors. For the sake of good order, it should also be pointed out that credit losses in the mortgage sector have so far been relatively moderate, despite the dramatic downturn.

The introduction of a leverage ratio

We do appreciate the intention to avoid extreme gearing, but a crude gross leverage ratio in our view is not the way forward and we strongly oppose the introduction thereof.

Further, we find that such a leverage ratio:

1) will negatively affect the resilience of the Danish mortgage finance system and financial stability. Mortgage bonds and covered bonds are low-risk bonds. Further, this is an area that is already extensively regulated by Danish legislation, e.g. through lending criteria/limits, loan-to-value (LTV) ratios, ongoing valuation and funding requirements. A crude leverage ratio is too simple compared with existing regulation.
2) will unintentionally hit mortgage credit loans and other products supporting the resilience of the Danish mortgage finance system such as off-balance-sheet products and repo transactions. These assets are characterised by low risk due to the above-mentioned legal framework

in Denmark, including strict collateral requirements. The leverage ratio would lead directly to higher costs for the customers and would negatively impact the real estate market and the wider economy.

3) will reduce the propensity for banks to hold mortgage bonds as a liquidity buffer – especially if mortgage bonds are subject to significant haircuts when calculating the liquidity ratios. We are of the opinion that the liquidity buffer should be excluded from the exposure (the denominator) in the calculation of the leverage ratio and that covered bonds that offer low risk and are highly liquid, such as Danish mortgage bonds, should be included in the liquidity buffer on a par with government bonds.

We would therefore suggest that a list of elements should be analysed, for example the impact on lending growth, growth in assets and risk profile in the individual assessment of a bank, i.e. we would suggest that the Basel Committee thinks in terms of elements and building blocks rather than a ratio.

Should the Basel Committee choose to go ahead and introduce a leverage ratio, it is crucial that it is imposed in a flexible way. In particular, it should merely serve as an indicator which could, in combination with a range of other key risk indicators, help supervisors assess an institution's capital strength within the pillar II framework.

Also, we find that it has to be clarified that the concept of leverage should apply only at a consolidated level for banking groups.

The definition of capital

Guarantee capital

We generally support the proposed eligibility criteria for capital instruments to qualify for inclusion in core tier I capital. The criteria under item 87 primarily aim at common shares. The Danish Bankers' Association (which also represents Danish savings banks and cooperative savings banks) appreciates that the Basel Committee acknowledges that the application of the criteria for capital instruments issued by non-joint stock companies should take into account their specific corporate form and legal structure.

The proposed criterion no. 3 ("Principal is perpetual and never repaid outside of…") gives rise to uncertainty as to whether the funding mechanism of savings banks and cooperative savings banks literally fulfils this criterion. The uncertainty arises from the fact that issued capital of the said institutions can under certain circumstances be repaid at the request of a guarantor or a member of the cooperative savings bank – see below.

It is paramount to ensure legal certainty concerning this existing and legislatively recognised funding mechanism and thus to ensure the continued funding of the said institutions. Please note that there are approximately 60 savings banks and co-operative savings banks in Denmark.

Savings banks
Danish savings banks are established as private, self-governing institutions (foundations), and are funded by guarantee capital. According to the Danish Financial Business Act, guarantee capital is fully equivalent to common share capital in terms of ranking lower than all other elements of funding, the capability of absorbing losses (also in period of market stress), and transparency with regard to the terms and conditions of the capital instruments.

Guarantee certificates are not and cannot be traded on a conventional market. Therefore, savings banks are allowed, at the request of a guarantor and typically after the expiry of a notice period, to repurchase guarantee certificates.

It is a precondition according to the Danish Financial Business Act that the savings bank also after the repurchase meets the capital requirements.

The guarantors have no right to claim repurchase, and during the financial crisis, savings banks actually suspended repurchases in order to ensure the presence of capital. The suspension was generally accepted by the guarantors due to the terms and conditions of the funding instrument.

Cooperative banks
The characteristics of the capital of cooperative savings bank are in all essentials the same as those of the guarantee capital described above. Cooperative savings banks can be independent institutions or (most of them) permanently affiliated to a central body. There is only one central body in Denmark. The commitments of the central body and affiliated institutions are either subject to joint and several liability or the commitments of its affiliated institutions are entirely guaranteed by the central body. Only customers (depositors or borrowers) can be members of cooperative savings banks and only under observance of certain conditions. After the termination of their business relationship with the cooperative savings bank, they may apply for the repayment of the invested capital.

A more flexible approach
Against this backdrop, we strongly ask for a flexible approach to ensure that national supervisors can interpret and apply the criteria set out in the annex in the light of the specific corporate form and legal structure of the said institutions.

Deductions
Regarding the definition of capital, we have the following remark: According to the Basel Committee, common equity should serve as the basis for all deductions that need to be made. We find that there has to be differentiation depending of the type of capital and its designation.

Equity investments in other institutions are one example where both tier 1 and tier 2 capital should be considered.

Collective investment units are another concern, where it is relevant to exempt these units from the deductions in capital – or at least to exempt units investing, for example, in government bonds and similar instruments. It seems illogical that there are exemptions for collective investment units investing in equity in companies that are not credit and financial institutions, since these types of investments are exempt if a credit institution chooses to invest in them directly.

The implementation process

In light of all the new regulatory initiatives on the agenda, we find it important to underline that the various new initiatives need to be analysed in entirety and not only through partial analyses. Otherwise, the initiatives could end up being counterproductive, because they involve double counting or mutually conflicting solutions. Also, we find that a principle of proportionality should be integrated into the initiatives, so that small and medium-sized banks can meet the standards.

Also the incentives in Basel II to develop an IRB approach would be highly reduced if the proposals are not changed.

Seen from a macroeconomic point of view, the timing of the new regulatory initiatives is essential, as the impact on the real economy will be significant. In this regard, we would suggest phasing in the new legislation, e.g. to lower the starting point and make recalibrations over several years before the final regulatory framework is determined.

The new regulatory framework will have a direct impact on the lending capacity of banks, and this will in turn feed into the rest of society. A large part of real property in Denmark is financed through the mortgage credit institutions. As a consequence of the proposal to introduce a leverage ratio and new liquidity regulation, covered bonds/mortgage-based lending would be restrained, and banks might decrease their holdings of these instruments, leading directly to higher costs of financing for retailers and corporates. The negative impact on the real estate market will feed into the wider economy. We suggest that the QIS involve macroeconomic impact studies to fully capture these consequences.

It should be kept in mind, though, that pressure from the market in itself could imply that banks would implement the rules before they are obliged to, i.e. optional transition rules might not be effective in this regard.

Yours sincerely

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