FINANSRÅDET

DANISH BANKERS ASSOCIATION

The Basel Committee on Banking Supervision
Bank for International Settlements,
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International framework for liquidity risk measurement, standards and monitoring

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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 – not only from the Basel Committee but also from others, we find it important to underline that the various new initiatives need to be fully 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. It is also very important from a Danish perspective that the new setup for liquidity risk measurement respects the unique Danish system of mortgage financing through the mortgage credit institutions.

As regards the paper: "International framework for liquidity risk measurement, standards and monitoring", we generally support designing a new framework that would reduce systemic liquidity risk and achieve global consistency in supervisory regimes across all material jurisdictions. We particularly welcome the proposed basic methodology to improve liquidity risk management, i.e. a Liquidity Coverage ratio covering the short-term liquidity risk and a Net Stable Funding ratio covering funding risk.

We would like to underline that we fully support the EBF position paper regarding the Basel Committee's "International framework for liquidity risk measurement, standards and monitoring" document. However, we would like to stress some areas that we, from a Danish perspective, are very concerned about:

- The definitions of liquid assets - the treatment of covered bonds

- The Net Stable Funding ratio– not suitable for the Danish model for mortgage lending

- Currency – acknowledgement of stable fixed exchange rate regimes

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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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1. The Danish Mortgage System

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 risk limits applying to interest, currency and prepayment risks are very narrow 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 18th 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

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too simplistic leverage ratio[1] 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.

2. The definitions of liquid assets - the treatment of covered bonds

The Basel Committee's proposal will be very counterproductive for covered bonds/mortgage-based lending in Denmark. This is due to the very narrow definition of liquid assets and the very harsh and simplistic treatment of covered bonds with assigned haircuts of 20 or 40 percent.

These large haircuts do not reflect the high quality of the bonds. They will significantly reduce the incentive to hold these bonds and in effect make the definition of the liquidity buffer too narrow. In comparison, the Danish covered bonds are eligible for lending at the Danish central bank with haircuts from 1 to 7.5 percent (the haircut depends on the maturity of the covered bond).

In Denmark covered bonds play a significant and often dominant role in the management of risk and liquidity in the financial sector. It will not be possible to replace the covered bonds by government or central bank instru-

[1] It is highly relevant to look at the various regulatory initiatives combined. For our comments on the Basel Committee's International framework for strengthening the resilience of the banking, please refer to the separate response from the Danish Bankers' Association. This response also represents a Danish angle.

ments because the supply of such Danish krone-denominated assets is too small. This can be illustrated by the fact that the Danish covered bond market – as mentioned above - is the second largest covered bond market in Europe, and the current outstanding amount of Danish covered bonds is four times larger than the size of the Danish government bond market.

Covered bonds are therefore an integral part of the management of risk and liquidity in the financial sector. The Basel Committee's proposal of a 50-percent limit for the inclusion of covered and cooperate bonds in the overall stock of liquid assets will therefore reduce the Danish banks ability to hold covered bonds as a part of their liquidity management. This will have severe consequences for the Danish market for covered bonds and will lead directly to higher mortgage finance costs.

Furthermore the price volatility of Danish covered bonds is very similar to the price volatility of Danish government bonds, and Danish covered bonds are among the highest rated covered bonds with international credit-rating agencies – their rating is almost as high as government bonds. At the height of the financial crisis in the fall of 2008 the bid-offer spread for Danish government bonds was at times higher than that of Danish covered bonds. This illustrates that the Danish covered bond market was more liquid than the Danish government bond market during some of the worst periods of the crisis.

Finally the proposal will have a severe negative impact on the financing of private real estate as well as SME and commercial property in general. In many countries, covered bonds are used as an important funding source for such financing, and directives have been issued to ensure proper regulation of the issuance of such instruments. As a consequence of the proposal, covered bonds will lose value in the liquidity buffer, and banks might decrease their holdings in these instruments leading directly to higher costs of financing for households and businesses. Such a negative impact on the housing market will spill over to the economy as a whole.

On the basis of the high quality of Danish covered bonds most recently demonstrated under the financial crisis as described above, the Danish Bankers Association urges the Basel Committee to develop the model further in two ways: First we find that there are strong arguments for allowing Danish covered bonds in the liquidity buffer on equal terms with government bonds. Second we find that the risk inherent in the different bonds should be reflected in the haircuts. This could be achieved by more frequent use of ratings and by considering the maturity of the bonds. This would give AAA rated covered bonds a more fair treatment.

In respect to the Basel Committee's proposal to prohibit covered bonds in the liquid assets if the bonds are issued by the bank itself, it does not seem logical to include bonds when they are in the hand of one bank, and then exclude them in the hand of another bank. The asset pool backing of the covered bonds and the strict criteria for their composition ensure the quality

of the individual bond. Furthermore the Danish mortgage credit institutions perform match-funded operations under a strict balance principle and strict eligibility criteria as described above. This ensures a high quality of the mortgages backing the mortgage bonds and in effect eliminates the liquidity, interest rate and currency risks from the mortgage credit institutions. The result is that the risk of the bonds is primarily linked to the quality of the asset pool.

Secondly mortgage credit institutions must at all times be able to demonstrate the availability of eligible collateral sufficient to cover the value of mortgage bonds issued. Danish mortgage credit institutions are therefore prohibited by legislation from issuing mortgage bonds into their own portfolios for the purpose of raising liquidity.

The supporting quality of the covered bond largely separates the investor in the bond from the issuer and therefore it should not be necessary to prevent a bank from holding bonds issued by the bank itself.

3. The Net Stable Funding Ratio– not suitable for the Danish model for mortgage lending

The objective of the Net Stable Funding Ratio is to promote resilience over a long-term time horizon by creating additional incentives for banks to fund their activities with more stable sources of funding on an ongoing structural basis. The NSF ratio is intended to promote long-term structural funding of banks' balance sheets, off-balance-sheet exposures and capital market activities.

In general, the Danish Bankers Association welcomes the objectives of the Net Stable Funding ratio but a major problem with the NSF ratio is that one size does not always fit all.

The Danish mortgage system is characterised by its strong legal framework, strict regulation of the mortgage credit institutions and the fact that the supervision of the mortgage credit institutions is undertaken by a dedicated division of the Danish FSA. The limits on interest, currency and prepayment risks for the mortgage credit institutions are very strict, and they have to comply with the balance principle. The mortgage credit institutions are monoline businesses, and they are permitted only to provide mortgage financing and issue bonds. As a consequence, they are not allowed to accept deposits, and the Danish mortgage credit institutions are therefore not threatened by bank runs.

Mortgage loans can have fixed or variable interest rates. The NSF ratio is a problem for the variable-rate loans, which account for about 50 percent of the outstanding mortgage loans.

The interest rate for most variable-rate loans is reset annually. For a loan with at maturity of 30 years, the interest rate is therefore reset 29 times. The interest rate of the mortgage loans is adjusted by issuing new covered

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bonds with a maturity of one year each year. As regards the refinancing of the mortgage loans each year, it is important to stress that all refinancing risk is on the borrowers and not the mortgage credit institutions. This is due to the fact that the interest rate on loans is directly linked to the interest rate of the newly issued covered bonds.

This way of doing business is in conflict with the NSFR proposed by the Basel Committee because funding with a maturity of less than one year is not recognised as available stable funding.

The Danish Bankers Association does not find any evidence of a need for mortgage credit institutions operating under the Danish regulatory framework to comply with the NSFR as outlined in the consultation document. The recent financial crisis showed that Danish mortgage credit institutions were able to continue lending activities throughout the entire crisis because new covered bonds were saleable. The Danish market for covered bonds was never closed during the fall of 2008 although there were large sellers in the market.

Furthermore, the mortgage credit institutions had to reset interest rates for many variable-rate loans during the peak of the crisis in December 2008. As a consequence, mortgage credit institutions had to sell a large number of covered bonds in replacement of bonds maturing. Despite the crisis, it was possible to sell covered bonds of more than EUR 50 billion.

The Danish Bankers Association therefore urges the Basel Committee to develop the model further to recognise the unique features of the Danish model for mortgage lending.

4. Currency – recognition of stable fixed exchange rate regimes
Paragraph 33 states that the bank should be able to use the stock of liquid assets to generate liquidity in the desired currency and in the jurisdiction in which the liquidity will be required. As such, banks are expected to be able to meet their liquidity needs in each currency and maintain high-quality liquid assets consistent with the distribution of their liquidity needs by currency.

The Danish Bankers association in general supports that banks should be able to meet their liquidity needs in each currency. But is it also important to recognise stable fixed-exchange-rate regimes.

The Danish currency has been pegged to the euro (or D-mark) for the past 28 years. As a consequence of this very stable fixed exchange rate regime, much of the funding of the Danish banks is euro-denominated. We therefore find that there is a need for the Basel committee to develop the model further to recognise stable fixed exchange rate regimes.

Furthermore, the model should recognise that, although the basic principle is matching inflows and outflows in each currency, it is possible to some ex-

tent for each bank to use a part of a surplus of liquidity in one currency to match a liquidity deficit in another. This was also the case during the crisis, but it is particularly relevant when liquidity in one of the smaller currencies is needed and surplus liquidity in one of the major currencies exists. Each bank should make explicit assumptions if currency conversion is possible, and such assumptions should then be reviewed by the local supervisor.

Yours sincerely

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