Realkreditrådet
ASSOCIATION OF
DANISH MORTGAGE BANKS

To: The European Banking Authority

Copenhagen
20 March 2014

Answer submitted by:

Realkreditrådet (Association of Danish Mortgage Banks)

Comments on EBA's Consultation Paper on draft guidelines on disclosures of encumbered and unencumbered assets

Dear Sir or Madam,

The Association of Danish Mortgage Banks appreciates the opportunity to comment on the draft guidelines on disclosure of encumbered and unencumbered assets.

General remarks

EBA decided to follow a definition of encumbrance based on solvency considerations in their final draft ITS on asset encumbrance for regulatory reporting and the draft guidelines in consultation will form the basis of the binding technical standards on the more extensive disclosure that the EBA will have to develop by 2016.

Spill-over effects will be detrimental

On this backdrop, we would like to reiterate our concerns, that future references to the concept of asset encumbrance – e.g. the LCR liquidity definition according to article 416, 3 – might spill over to the definition being established now writ. Institutional disclosure[1].

Therefore we fully agree in the statement included in EBA's report on HQLA: " [...] the concept of encumbrance in the context of liquidity reporting should therefore differ from the interpretation of encumbrance applied for the reporting on asset encumbrance, which focuses solely on solvency"[2].

As an example, if the solvency based 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

[1] Theses concerns were also stated in our joint answer to EBA's consultation on Draft Implementing Technical Standards on Asset Encumbrance Reporting under article 100 of CRR (additional regulatory reporting).
[2] EBA: "Report on appropriate uniform definitions of extremely high quality liquid assets (extremely HQLA) and high quality liquid assets (HQLA) and on operational requirements for liquid assets under Article 509(3) and (5) CRR", December 2013, page 88.

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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".

Solvency based asset encumbrance reporting by Danish Mortgage Banks does not seem relevant

Danish mortgage banks are non-deposit taking institutions. In addition, covered bonds can only be issued against collateral in the form of mortgages. Therefore issuance of covered bonds can not lead to structural subordination of simple depositors. Concerning liquid assets in the cover pools, they are 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 – neither leads to any structural subordination of simple depositors.

Therefore reporting on asset encumbrance due to covered bonds issuance doesn't seem relevant[3]. If anything, this should be considered encumbrance "in the right direction".

Responses to specific questions

We do not have comments to the specific questions.

Yours sincerely
Realkreditrådet

Mette Saaby Pedersen
Department Manager

[3] 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

Appendix

The Danish mortgage system

Danish mortgage banks are specialized banks, which only grant loans against mortgages on real property by issuing covered bonds. Loans are granted at loan-to-value (LTV) ratios of up to 80% for private residential loans and typically up to 60% for other purposes, including commercial purposes. Mortgage banks have only one source of funding: bond sales. Thus, a mortgage bank does not operate in the same way as a commercial bank, which may take deposits or raise money market funding.

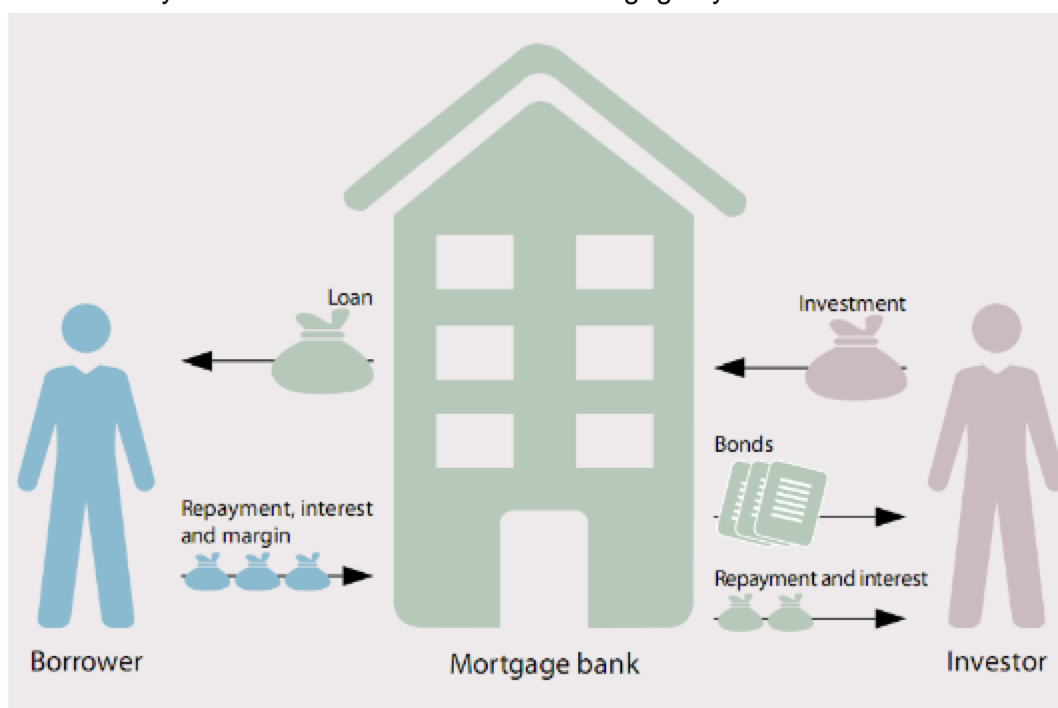
As the mortgage system is based on a principle of matching, all loans are matched with certain bonds (see chart 1). The loan type, repayment profile, term and currency thus determine which bonds the mortgage bank will sell. This ensures transparent loan costs, market-based prices, and unique prepayment options for borrowers. The match funding principle applies to all loans. In connection with adjustable-rate mortgages, the maturity of the underlying bonds is generally shorter than the loan terms. Here the match funding principle applies to the individual interest periods between refinancings. When the loan is refinanced, the underlying bonds are replaced. Further, the adjustable-rate mortgages are constructed in a way that ensures that the borrower (and not the mortgage bank) has the full refinancing risk – any change in interest rates is fully transferred to borrower.

All loans are funded on a current basis (tap issuance). That is, the mortgage bank issues the required bonds at the same time the loan is disbursed to the borrower. The prevailing market price consequently determines the loan rate faced by the borrower. In addition to the interest payment on the bonds, total costs also include a fee to the mortgage bank covering daily operating expenses and loan losses. Borrowers know which bonds fund their loans. As the bonds are listed on a stock exchange, borrowers can easily monitor market trends and thus the price they are paying. Borrowers may always prepay their loan by buying the underlying bonds in the market – this option is frequently used when market prices are in the favor of the borrowers.

Mortgage loans remain on the balance sheet of the issuing mortgage bank until maturity. The mortgage bank thus carries the credit risk on the loans until they mature. The mortgage bank thus have strong incentives to closely monitor the credit quality of its portfolio. In case of a loan defaulting, the mortgage bank will claim the underlying collateral (the real property). Danish law ensures a fast foreclosure process implying that the mortgage bank can easily access the collateral. Further, the borrower is subject to so-called full recourse liability which means that the mortgage bank can maintain a claim on the borrower, in case the realization of the collateral results in a loss for the mortgage bank.

The Danish mortgage system is based on a one-to-one relationship between Danish mortgage banks' lending and issued mortgage bonds. The covered bond market plays a very important role in the Danish economy due to its size. By end of January 2014, outstanding covered bonds amounted to EUR 366 corresponding to approx. 150% of Danish GDP. In comparison, outstanding government bonds amounted to EUR 100bn. The Danish covered bond market is Europe's third largest with the German Pfandbrief market as the largest and Spain as the second largest.

Chart 1 – stylized illustration of the Danish mortgage system



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.