MINISTRY OF ECONOMIC AND BUSINESS AFFAIRS
DENMARK

Michel Barnier
Commission for Internal Market and Services
European Commission
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MINISTER FOR ECONOMIC AND BUSINESS AFFAIRS

Dear Commissioner Barnier,

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I would like to take the opportunity to welcome the Commission's hearing on further possible changes to the capital requirements directive, based i.a. on the recent proposals from the Basel Committee on Banking Supervision. I support the overall objective of strengthening banking regulations, including liquidity standards, within a global framework.

However, I would like to raise some concerns regarding specific elements in the proposal that could have unintentionally adverse effects for the Danish mortgage finance system.

As opposed to certain other mortgage securities, which were major culprits behind the financial crisis, the Danish mortgage finance system is seen by many, including the Bank for International Settlement (BIS) as a model for how a mortgage system should be designed. Its characteristics have so far rendered the system robust in face of the difficulties stemming from past and present financial crises, and the new regulations should reflect and recognise this fact and the particular characteristics of the system.

The Danish mortgage finance system ("realkredit") is based on covered bonds issued in accordance with the EU directive on such bonds, but the bonds are also subject to a number of other safeguards that enhance investor protection further, in the form of a combination of tight regulation on the matching of cash flows on the loan and the funding side, liquid markets for the covered bonds of the mortgage finance institutions, and low credit risk. The credit risk is contained through strict observance of loan to value ratios, personal liability for the loans, a preferential treatment of investors in mortgage bonds and generally strong creditor protection within Danish law. For these reasons Danish covered mortgage finance bonds therefore carry interest rates within 100 basis points of the rate on Danish government bonds. Their price is as stable as most government bonds, including during the recent financial crisis, and the price shows only very limited positive correlation with indicators of financial turbulence. There is an active secondary market and ratings are higher than that of many EU government bonds.

I welcome the efforts of the Commission to establish a single rule book. In addition, I welcome the view of the Commission to keep some forms of flexibility with regard to regulation of real estate lending. In Denmark our regulation is two-stringed and distinguishes between banks and mortgage credit institutions, where both types of business organizations are credit institutions in the EU terminology. I would like to highlight that it is of paramount importance to Denmark and our financial stability, that the amendments remain sufficient flexible in order to safeguard a continuation of our system of mortgage credit under the framework of single rule book, where among others prudential rules a continuation of a statutory balance principle is desirable.

In the hearing document and the Basel proposal on liquidity risk, it is proposed to limit the share of covered bonds, together with corporate bonds, to 50 percent of a bank's liquidity and only after applying a haircut of 20 to 40 per cent. For the above mentioned reasons Danish banks use covered mortgage finance bonds, in particular those with short maturity, as a major component of their liquidity management. The most recent data show that covered bonds outnumber government bonds by a factor of more than 6 to 1 on the Danish bank's balance sheet. This also reflects that the outstanding amount of government bonds today is far too small to cater to the bank's need for liquidity instruments. The proposed definition of liquid assets would therefore give rise to serious problems for the Danish banking system and subsequently for the Danish covered bond market despite the high quality of the Danish covered bonds and the resilience of the mortgage finance system.

I would therefore suggest an alternative approach within which the liquidity of financial instruments can be assessed on the basis of factors relevant for the liquidity, independent of whether they are government bonds, covered bonds or corporate bonds, as explained in the accompanying memorandum by the Danish Central Bank and the Danish Financial Supervisory Authority. Haircuts can then be calibrated on the basis of such a system.

The memorandum also raises a few other issues, where the proposed measures would have material implications for the Danish mortgage financing system:

- The proposal on a *net stable funding ratio* will create problems for Danish mortgage loans that are financed through the issuance of short term covered bonds. According to the definition of stable funding, Danish covered bonds with a remaining maturity of less than one year are not regarded as stable funding. At the same time, loans with a maturity of more than one year are subject to a 100 per cent stable funding requirement.
- In relation to the *liquidity coverage ratio* it should be possible to take into account bonds that are already sold but not yet settled. The new short-term liquidity coverage ratio will require institutes to hold liquid assets that, as a minimum, match their liquidity requirements over a 30-day horizon. This will also create problems in relation to Danish adjustable-rate loans.
- We find that a *leverage ratio* should be part of the pillar 2 assessment, where the level can be based on the business model of the credit insti-

tution. Unlike the usual capital requirement, the proposed leverage ratio would disregard whether the loans granted by the institute are good or bad. Particularly for the Danish mortgage-credit institutes, which are characterised by a very low credit risk, a universal capital requirement that does not take into account the specific circumstances of the institute may result in much higher levels that do not reflect the actual underlying, more limited risks of the mortgage-credit institutes.

I look forward to discuss these issues further with you and your staff and would like to offer the relevant Commission services a visit from our experts in order to elaborate further on the issues and discuss possible ways to address them.

Please note that Danish authorities in addition to the present letter reserve the right to respond to the hearing with an input covering other points included in the hearing document.

Yours sincerely,

Brian Mikkelsen

Brian Mikkelsen
Minister of Economic and Business Affairs