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23 august 2010

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To The Basel Committee on Banking Supervision

Danmarks Nationalbank and Finanstilsynet strongly supports the aim of the Basel Committee's capital and liquidity reform package. We are however deeply concerned with the treatment of Danish covered bonds in the definition of liquid assets in the Liquidity Coverage Ratio. It is our assessment that the proposal of the 26th of July 2010 is more likely to increase the risk of instability in the Danish financial system and thus run counter to the overall aim of the reform package.

First, the proposal accords a much lower weight to covered bonds than government bonds in the Liquidity Coverage Ration (LCR) formula. We do not find that this is warranted by empirical evidence. In fact, the liquidity of Danish covered bonds has proven on par with that Danish Government bonds in times of severe financial stress.

Second, covered bonds are the predominant asset in the Danish financial market, and an important component of Danish financial institutions liquidity management. This is clearly illustrated by the shortfall in liquid assets for Danish banks under the proposal. This will be equivalent to approximately 81 per cent of the total outstanding amount of DKK denominated government bonds at end-2009.

We, therefore, strongly suggest that a solution is found under which the liquidity of high quality covered bonds like Danish covered bonds is taken more appropriately into account.

Please see the accompanying note for a more detailed explanation of our concerns and a possible solution.

Yours sincerely,

Nils Bernstein

Ulrik Nødgaard

DANMARKS NATIONALBANK

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Danish covered bonds and the Liquidity Coverage Ratio (LCR)

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Covered bond liquidity is on par with that of Government bonds

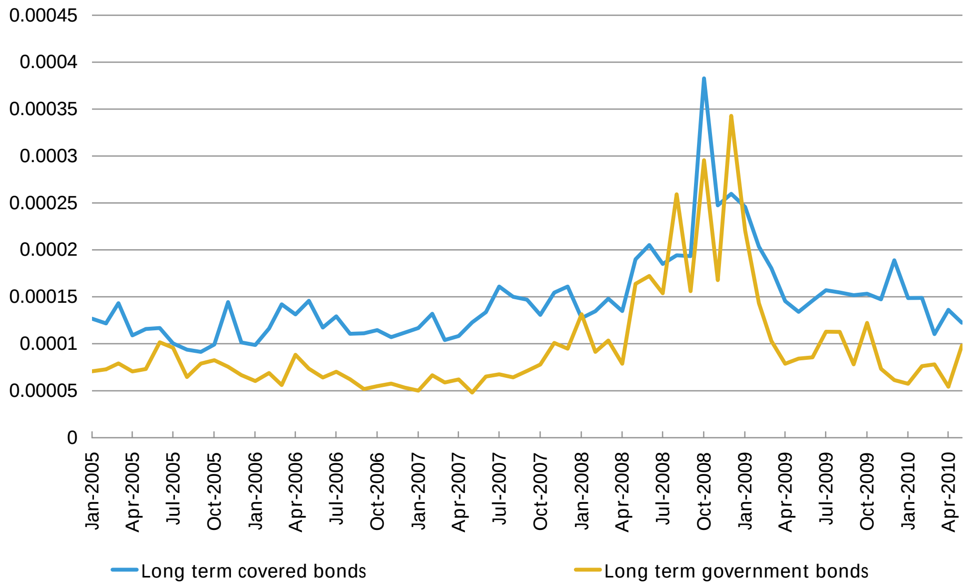
Danmarks Nationalbank is currently carrying out a study comparing the liquidity of the Danish government bond and covered bond markets before, during, and after the financial crisis based on a micro dataset. Due to the perspective of the study on liquidity risk management the study focuses on wholesale trades in the large bonds of the two markets. So far the empirical evidence does not support the idea that government bonds are more appropriate instrument in banks' liquidity pools than Danish covered bonds to the extent reflected in the revised LCR proposed on the 26th of July 2010. In fact, there was an increase in the number of trades, the median trade size as well as the turnover rate in the short end of the covered bond market during the crisis.

Thus during the financial crisis long term covered bonds were just as liquid as long term government bonds, while short term covered bonds were actually more liquid than government bonds.

This can be documented by looking at an often used measure of illiquidity, namely the percentage price change divided by trade size[1]. Based on this measure a tendency can be seen that before the crisis government bonds were slightly more liquid than covered bonds, cf. chart 1 and 2, and this normal relationship has be re-established. Furthermore the short term covered bond market has been as liquid as the long term government bond market.

[1] Amihud, Y. (2002). Illiquidity and Stock Returns: Cross-Section and Time-Series Effects. *Journal of Financial Markets* *5*(1), 31-56.

MONTLY MEDIAN OF PERCENTAGE PRICE CHANGE DIVIDED BY TRADE SIZE Chart 1



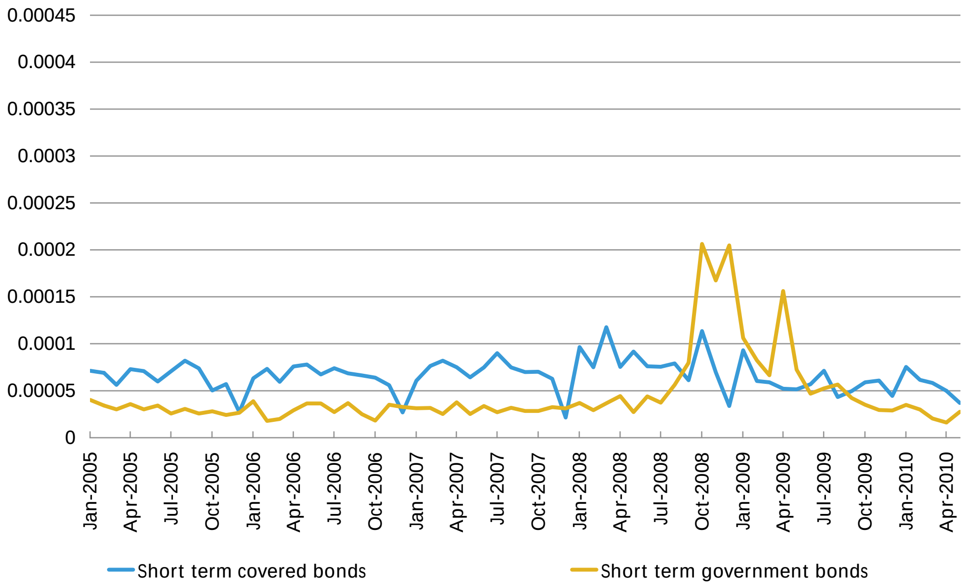
Note: Long term covered bonds are defined as long term callable mortgage-bonds. Long term government bonds are defined as government bonds with time to maturity of more than five years.
Source: Danish Financial Supervisory Authority, Nasdaq OMS and own calculations.

The illiquidity measure for both the long term government and covered bond market increased significantly during the crisis. However, the level of the illiquidity measure was almost the same for the two markets during the peak of the crisis. This does not take into account the temporary measures undertaken during the financial crisis to support the Danish pension sector.

In the short end of the markets the illiquidity measure was higher for government than covered bonds during several months of the crisis. Part of this result can be explained by the fact that the short term government bonds, being defined as bonds with time to maturity of less than five years, generally have a longer time to maturity than the short term covered bonds.

However, the very short end of the government bond market would by no means be sufficient to cover the banks need for liquid assets under the Basel proposal. Actually, the Basel proposal would induce the banks to hold long term government bonds as liquidity, cf. the calculations below based on the Quantitative Impact Study (QIS).

MONTLY MEDIAN OF PERCENTAGE PRICE CHANGE DIVIDED BY TRADE SIZE Chart 2



Note: Short term covered bonds are defined as fixed-rate bullet mortgage bonds. Short term government bonds are defined as government bonds with time to maturity of less than five years.
Source: Danish Financial Supervisory Authority, Nasdaq OMS and own calculations.

The high liquidity of Danish covered bonds during the crisis can in large part be attributed to the history and institutional setup of Danish covered bonds. In Denmark there is a very long history for issuing covered bonds under a strict legislative framework. Danish covered bonds are, on top of the general characteristics of covered bonds, issued under a very strict "balance principle" that strongly limits the issuers' ability to assume any risks other than credit risk. In practice the vast majority of loans financed by covered bonds have loan terms including interest rate and method of prepayment which are set with direct reference to the terms of the covered bonds issued to fund the loan. As the bonds are exchange-listed the system is highly transparent. The close link between loans and bonds makes it possible for the borrowers to repay their loans by buying the underlying bonds. Thus the covered bonds cannot trade with a very large discount compared to the credit quality of the cover assets without attracting buy-side interest from the borrowers. The strict balance principle also strongly limits the mortgage banks' ability to assume any other risks than credit risk. The credit risk is contained by a number of measures. Besides the maximum loan-to-value ratio of 80 pct. at all times of the loan, mortgages have a strong legal position in Denmark. The mortgage banks possess a senior claim on the proceeds from a property sale in the event of a borrowers default. The Danish foreclosure processes are fast at relatively low cost and strategic default by borrowers is eliminated by borrowers' personal liability in the Danish legislation.

The high quality of the Danish covered bond system has also been demonstrated by the fact that the system has worked well in providing a stable source of credit to households and firms during the financial crisis. In fact increased lending funded by covered bonds has offset a fall in lending by the rest of the banking system. Its significance can also be illustrated by the fact that the market value of all covered bonds is more than EUR 300 billion. This is equivalent to 1.4 times Denmark's GDP and 7.6 times as large as the Danish government debt.

Covered bonds are central to Danish banks liquidity management

The results of the Quantitative Impact Study (QIS) underline the importance of the covered bond market to the Danish financial sector. Table 1 shows weighted average estimates of the Liquidity Coverage Ratio for the Danish institutions taking part in the QIS.

LCR ESTIMATES FOR DANISH QIS BANKS (WEIGHTED AVERAGE) Table 1

Limit on Level 2 assets	Baseline scenario of December 2009 proposal	Broad buffer scenario of December 2009 proposal	Scenario of GHoS press release of 26 July
0 per cent	34 per cent		
40 per cent		56 per cent	59 per cent
50 per cent		68 per cent	71 per cent
100 per cent		81 per cent	89 per cent

Note: Calculations under the GHoS scenario are made under simplifying assumptions given the level of detail in the original QIS While the GHoS scenario stipulates a limit on level 2 assets in the portfolio of liquid assets at 40 pct., calculations have also been made based on alternative limits but using the same stress scenario. Own issued covered bonds currently held in the portfolio of liquid assets are excluded from the calculation

Under the baseline scenario of the Basel December 2009 proposal the Danish banks obtain a weighted average Liquidity Coverage Ratio (LCR) of 34 per cent. Allowing covered bonds to be included in the portfolio of liquid assets significantly improves the LCR, up to a level of 89 per cent given full inclusion. The substantial impact on the LCR is due to the relatively small government debt market in Denmark and a large and well developed covered bond market. Covered bonds are the predominant asset in the Danish financial market, and an important component of Danish financial institutions liquidity management. In 2009 one third of the Danish mortgage bonds were held by monetary financial institutions.

Under the July 26th scenario of the Group of Governors and Heads of Supervision (GHoS) the total shortfall in liquid assets is EUR 28 billion for the Danish banks taking part in the QIS. This is equivalent to 49 per cent of the total outstanding amount of DKK denominated government bonds excluding holdings in government funds at end-2009, c.f. table 2.

NOMINAL AMOUNT OF DKK GOVERNMENT BONDS AND DKK COVERED BONDS IN CIRCULATION AT END 2009, DISTRIBUTED BY REMAINING TIME TO MATURITY Table 2

Billion EUR	time to maturity <= 5 years	5 years < time to maturity <= 10 years	Time to maturity > 10 years	Total
Outstanding amount of DKK government bonds	29,9	22,9	15,2	67,9
- Amount held by government funds	7,2	1,9	1,3	10,4
- Amount held by Danish monetary financial institutions	3,1	4,2	0	7,3
Remaining amount of DKK government bonds in free circulation	19,6	16,7	13,8	50,2
Outstanding amount of DKK covered bonds	197,9	29,8	135,2	362,9

Source: Danmarks Nationalbank

Extrapolating the shortfall figure to the entire Danish banking sector on the basis of total assets, and subtracting any current holdings of Danish government bonds by Danish monetary financial institutions, the shortfall is equivalent to 81 per cent of Danish government bonds in circulation. Requiring Danish financial institutions to hold such a very large proportion of the government bonds in circulation in a liquidity buffer would in itself negatively impact the liquidity of these bonds.

Finally, as evident from table 2, a large proportion of Danish government bonds outstanding are very long-term bonds, not well suited as liquidity risk management instruments. In contrast, a large amount of short term covered bonds exist.

Conclusion

In conclusion, Danish covered bonds have proven to be very liquid even during times of stress and are subject to a very strict legal structure. Hence, there is no evidence to support the treatment of Danish covered bonds vis-a-vis government bonds in the current proposal. In addition, the large and important Danish covered bond market in combination with a significant shortfall of government bonds under the current proposal may create severe tensions in the Danish financial system. We therefore strongly suggest that a solution is found under which the liquidity of high quality covered bonds like Danish covered bonds is taken more appropriately into account.

High quality covered bonds should be included in the definition of "level 1" liquid assets. If not, the cap on high quality covered bonds should be lifted considerably. Given the insufficient availability of currently defined "level 1" assets in Denmark, a solution must be found so that Danish high quality covered bonds can be included as liquid assets in the LCR of Danish banks to a higher extent than the current proposal allows.