MINISTRY OF BUSINESS AND GROWTH
DENMARK

Commissioner Jonathan Hill
European Commission
DG Financial Stability, Financial Services and Capital Markets Union
Brussels

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Dear Commissioner Jonathan Hill

Thank you for the opportunity to respond to the Commission consultation on covered bonds in the European Union.

As I am sure you are aware, covered bonds play a very important role in the Danish economy due to the well-functioning Danish mortgage credit system. More than 60 per cent of domestic lending to companies and households is based on covered bonds and the Danish covered bond market is among the largest in Europe also in absolute terms. In light of our long and positive experiences with covered bonds I appreciate the Commission’s intention to explore the considerable potential in a more integrated covered bonds market in Europe building on and taking into account well-functioning national systems.

I believe that a covered bonds framework in the European Union building on core elements of the Danish mortgage credit system would create the right conditions for an increased use of covered bonds across Europe.

I would like to point out a couple of useful facts about the Danish mortgage credit system which highlight the stability of our framework. First, Danish mortgage credit institutions have historically experienced very low losses – also during periods of economic and financial stress. No Danish mortgage credit institution has ever defaulted and their covered bonds have never led to credit losses for investors. This was also the case during the recent financial crisis.

From mid-2007 to mid-2013 housing-prices in Denmark fell around 20 per cent. Nevertheless, the Danish mortgage credit institutions fulfilled the requirements as laid down in CRD III and raised additional collateral. During this period the Danish mortgage credit institutions even raised collateral above the legal requirements.

Secondly, Danish covered bonds were just as liquid as Danish government bonds during the financial crisis. The proven high liquidity characteristics of Danish covered bonds are also to a large degree reflected in the treatment of level 1 covered bonds in the LCR. This underlines the robustness of the system and the quality of such bonds as liquid assets.

Following the above, Danish covered bonds are very secure AAA-rated products and I believe that experiences can be gained from our system. At the same time, I find it important to highlight that developing a European covered bond framework should not become a one-size-fits-all exercise. As pointed out by the Commission, European action in this area must build on and leave room for existing well-functioning national covered bond markets.

In this context it is important to keep in mind that in some markets mortgage credit institutions are specialised institutions whose assets are in fact limited to cover pools and which cannot take deposits. Specialised institutions are not exposed to the same risks as universal banks. For example, there is no risk of a bank run in a specialised institution and all loans are mortgages secured by real estate subject to specific loan-to-value (LTV) limits. In the same vein, asset encumbrance is not a problem as there are no depositors and, following this, creditors are only bondholders or junior creditors.

Another difference between a specialised institution and a universal bank is that it is not possible to exclude loans from the cover pool in a specialised mortgage credit institution – either wholly or in part. This follows from the match funding principle which ensures a close match between a loan and the bonds funding the loan. Furthermore, an exclusion from the cover pool would require the use of other loan funding instruments, which are not present in non-deposit taking Danish specialised mortgage credit institutions.

As a consequence of these differences between specialised institutions and universal banks, specialised institutions should not always be subject to the same requirements as universal banks, whose assets are wider spread and not limited to a cover pool.

From a Danish point of view, it would be vital that core elements of the Danish mortgage credit system are maintained, including:

- Specialised institutions funding loans solely through the issuance of bonds and not e.g. through deposits,
- Match funding, where there is a close match between a loan and the bonds funding the loan which effectively limits market and funding risk,
- The balancing principle, which effectively limits both liquidity and market risk,

- A capital centre structure with separate risk-based capital requirements to each centre and to the mortgage credit institution in general in order to account for loan loss risk in different stress scenarios,
- A capital centre structure without requirements specifying that each capital centre should be a separate legal entity,
- Specialised insolvency rules enabling a non-forced and gradual winding down of the mortgage credit institution.

To the extent that it proves possible to maintain such features, the Danish government is supportive of further regulatory convergence in relation to covered bonds in the form of an EU directive. We support a directive and not a regulation as a directive entails national flexibility when implementing the directive into national legislation. This national flexibility is important in order to take national specificities into consideration.

I look forward to our continued dialogue on the future of covered bonds in a European context just as my services are ready to engage with the Commission for any further information that your services may require.

In the enclosed annex you will find answers to the specific questions in the Commission consultation paper.

Yours sincerely,

Troels Lund Poulsen