Realkreditrådet
ASSOCIATION OF
DANISH MORTGAGE BANKS

The Finansial Stability Board

jhh
S508 - D27890

e-mail: fsb@bis.org

Answer submitted by:
Realkreditrådet (Association of Danish Mortgage Banks)

Consultation response concerning Effective Resolution of Systemically Important Financial Institutions

We thank you for the opportunity to respond to the questions asked in the consultive document concerning *Effective Resolution of Systemically Important Financial Institutions.*

General Comments

We welcome and support the Boards work on a global resolution framework for global systemically important financial institutions.

Fundamentally, we find it important that such regulation is in line with general regulation, eg company, insolvency law and already implemented resolution regimes for financial institutions.

Answers

Q1. *Comments is invited on whether Annex 1: Key Attributes of Effective Resolution Regimes appropriately covers the attributes that all jurisdictions' resolution regimes and the tools available under those regimes should have*

Answer: An effective resolution regime should protect secured creditors. Therefore covered bonds should be mentioned in the Preamble in Annex 1 where an effective resolution tool ensure continuity of payments to investors in covered bonds and protect the investors like the protection of depositors.

Q6. *What classes of debt or liabilities should be outside the scope of statutory bail-in powers?*

Answer: Covered bonds should clearly be outside the scope of bail-in powers. It is also crucial that derivatives which relates to secured creditor claims are protected from bail-in in the same way as the covered bonds. This is already today a part of the Danish resolution regime for covered bonds.

Details on Covered Bonds and crisis management regimes

We are pleased to find that secured creditor claims (eg. covered bonds) are directly excluded to be exposed to statutory bail-in (Annex 2 section 3,1). It is imperative to us that the strength of the European covered bond systems crisis management regime will remain undimished.

Zieglers Gaard
Nybrogade 12
DK-1203 København K
Tel: +45 33 12 48 11
www.rkr.dk
rr@rkr.dk

European covered bond systems eg the German and Danish systems, already have effective crisis management regimes. The quality and robustness of these regimes indeed were acknowledged by the financial markets, due to the fact that covered bonds trade were kept at normal levels during the peak of the financial crisis.

The continued existence of these systems is crucial to investor confidence and covered bond ratings and consequently to the prices of loans funded by covered bonds.

This above applies to systems in which issuers' liabilities include both deposits and covered bonds (banking) as well as systems without deposits (mortgage lending).

In both types of system, covered bonds are issued out of a cover pool, and the issued bonds have a preferential claim on the cover assets. In case of an issuer's bankruptcy, the cover pool (loans and covered bonds) is segregated and treated separately in order that payments to investors may be continued and borrowers may retain their loans. The main consideration is to secure timely settlement of future obligations to covered bond investors. Fast generation of liquidity is consequently not required. On the contrary, accelerated resolution would very likely destroy values to no purpose.

This is very different from the resolution of banks in general where the main purpose is to secure guaranteed depositors access to their liquid funds. Here, a process is needed under which sufficient liquidity is secured fast in order to be able to continue part of the banking operations. If liquidity is not to be obtained from public sources, it must be provided indirectly by creditors through a write-down of their claims. Such write-down facilitates the sale of assets to parties that may provide liquidity.

A detailed description of the Danish mortgage system including resolution arrangements is attached as Appendix A.

Yours sincerely

Jan Knøsgaard

Jan Knøsgaard
Deputy Director General

Appendix A

Danish covered bonds

Structure and history

Danish covered bonds may be issued either by mortgage lenders (specialised banks offering loans funded by covered bonds) or through segregated cover pools on the balance sheets of banks. Danish mortgage lenders are subject to special legislation and represent about 95% of the total Danish covered bond market.

The following description is therefore based on the covered bond issuance of Danish mortgage lenders, but it widely covers that of Danish banks as well.

Current Danish mortgage legislation aims to ensure that issued covered bonds are highly secure. To this end, the legislation prescribes continuous LTV (loan-to-value) compliance, with an 80% LTV limit for private residential housing and a 60% LTV limit for commercial properties. Further, the issuance of covered bonds in Denmark is subject to the balance principle. The balance principle ensures that an issuer assumes no significant risks, such as interest rate risk, liquidity risk or currency risk, other than credit risk in respect of its customers. Finally, issuance is subject to a match funding principle, according to which the payments on covered bonds sold fully match the interest payments received from borrowers.

The issued loans remain on the balance sheets of the mortgage lenders until maturity, and the greatest risk assumed by a mortgage lender is credit risk in respect of borrowers. Mortgage lenders issue covered bonds out of capital centres (cover pools), which are on their balance sheets and consequently subject to financial legislation and control. Banks issue covered bonds out of registers that are very similar to capital centres and subject to very similar legislative treatment.

Mortgage lenders obtain funding by issuing securities registered in a central securities depository. The assets of a cover pool include the issued loans as well as highly secure securities, and the liabilities include the issued securities and equity.

The Danish mortgage bond market plays a very important role in the overall Danish economy. Outstanding covered bonds amount to about 134% of GDP. The Danish mortgage bond market is the second largest in Europe – only surpassed by the German market. The outstanding amount of mortgage loans in Denmark is DKK 2,350bn (about EUR 315bn), which means that the average mortgage loan per Danish citizen is DKK 427,000 (about EUR 57,000). The outstanding amount of bank loans is only DKK 1,300bn[1] (about EUR 174bn).

Danes have a long-standing tradition of owning their home. The main source of finance is mortgage loans, which are cheaper for borrowers than bank finance.

[1] Cf Danmarks Nationalbank, Monetary Review, 2nd Quarter 2011.

The Danish system has operated smoothly for 200 years, and no issuer has ever gone bankrupt. Loan losses have amounted to less than 1% of lending – even during the Great Depression. During the recent financial crisis, losses including commercial properties amounted to about 0.2% pa of total lending.

Throughout the financial crisis, Danish covered bonds were traded in larger volumes than sovereign debt, and Danish mortgage lenders remained able to fund loans by issuing covered bonds without any need for government purchases or government guarantees of the bonds.

Regulation and control

Mortgage lenders 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 lenders must comply with a wide range of requirements based on the CRD requirements applying to credit institutions. In case of gross or repeated violation of the Danish Mortgage-Credit Loans and Mortgage-Credit Bonds etc. Act or the Danish Financial Business Act, the licence to carry on mortgage lending may be withdrawn. It is assumed that withdrawal of a licence will only be relevant in situations akin to bankruptcy where the institution is unable to meet the statutory capital adequacy requirements or make payments to investors and other creditors or is otherwise unable to comply with the provisions of the Danish Financial Business Act.

The rules for resolving a mortgage lender are detailed and well considered.

The main considerations are to ensure (i) that bond investors receive timely payments and (ii) that the rights of borrowers are not prejudiced materially.

Balance sheets of Danish mortgage lenders 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 lender in order to protect covered bond investors.

If a mortgage lender is declared bankrupt, a trustee in bankruptcy is appointed. The Danish FSA may declare a mortgage lender bankrupt.

The trustee looks after the interests of the estate in bankruptcy, ie the interests of the creditors and particularly the covered bond investors in relation to the individual capital centres. Today, the creditors of a mortgage lender are almost exclusively covered bond investors. 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 lender is declared bankrupt, no acceleration therefore takes place in respect of covered bond investors or borrowers. 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.

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 lender as grounds for a claim of default. Similar rules apply to counterparties to financial instruments used to hedge risk in a capital centre.

Most mortgage lenders have several capital centres on their balance sheets. The capital adequacy requirement laid down in Danish legislation must be complied with by the mortgage lender as a whole, but also by the individual capital centre. If a capital centre ceases to meet the statutory capital adequacy requirement, the mortgage lender must provide supplementary capital to the capital centre in order to restore compliance unless such provision would cause the mortgage lender to become non-compliant in terms of capital adequacy.

It should be noted that a mortgage lender is not considered insolvent if it fails to meet its payment obligations to holders of subordinated debt (subordinate loan capital and hybrid core capital). Consequently, holders of subordinated debt cannot lodge a creditor's petition for bankruptcy.

The trustee cannot make payments to investors at dates earlier than the due dates of the payments. Therefore, investors cannot demand premature performance of a mortgage lender's payment obligations on the grounds of a bankruptcy order. Payments to bondholders are made from funds available for the payments.

The practical duty of a trustee is to simulate a going concern. Borrowers' rights in respect of prepayment are unchanged. The trustee must, as far as possible, continue to make payments to bond investors and to look after the interests of existing borrowers. The trustee may not issue new loans or otherwise expand business, as the mortgage lender's licence to carry on mortgage banking has been withdrawn.

The trustee may issue bonds to refinance bonds which have matured (adjustable-rate mortgages). The refinancing bonds will be as secure as the bonds they replace. But such issuance may only take place if the trustee deems that there are "sufficient funds" to satisfy the claims of creditors.

The trustee may also raise other loans for the purpose of paying bond investors. Such loans cannot be secured against existing mortgages, as these already serve as security for the issued covered bonds.

The trustee may transfer a total capital centre to another mortgage lender as an independent asset. A full transfer must be authorised by the Danish Minister for Economic and Business Affairs. Bondholders do not have a right of early redemption as a result of such transfer. Transfer in cases other than bankruptcy/suspension of payments requires the consent of creditors in accordance with the general rules of Danish legislation on the change of debtors as well as prior public authority approval.

If a mortgage lender is declared bankrupt, the assets, after deduction of estate administration costs, are distributed in the following order of priority:

Cover pool assets

1. Costs relating to trustee and necessary staff and other operating costs, such as IT etc.
2. Claims of covered bond holders, plus interest
3. Claims of junior covered bond holders

Assets of mortgage lender available for distribution

4. Priority claims of trustee
5. Employee claims
6. Duty claims
7. Residual claims of covered bond holders whose claims were not satisfied by the capital centre
8. Unsecured claims, including senior debt
9. Subordinate loan capital
10. Hybrid core capital
11. Claims of shareholders

Counterparties to financial instruments used to hedge risk in a capital centre rank pari passu with covered bond holders in the relevant capital centre.

Proceeds from loans raised for the purpose of overcollateralization (junior covered bonds) will serve to satisfy the claims of covered bond holders in case of bankruptcy. Any excess funds will be repaid to the lender.

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 lender but only by ordinary market changes.