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ASSOCIATION OF
DANISH MORTGAGE BANKS

To: EBA

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15th. of June 2012
S666 - D40759

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

Subject: EBA/DP/2012/2

Response to EBA Discussion Paper on a Template for Recovery Plans

The Association of Danish Mortgage Banks welcomes the opportunity to comment the EBA Discussion Paper on Template for Recovery Plans. The Association of Danish Mortgage Banks has taken note that the questions are specifically addressed to deposit taking credit institutions and we are therefore in a position where we cannot answer the specific questions. Instead of answering the questions in detail we would like to share some principal statements, which are of importance for the Danish specialised mortgage banks.

In our opinion the Template does not take into consideration the differentiation which exists among credit institutions in Europe with very different legislations in most countries and therefore also differentiated recovery plans. In Denmark ie, a distinction is made between different kinds of financial institutions – eg credit institutions are institutions that may receive deposits or other repayable funds from the public and mortgage banks are institutions that provide loans funded by mortgage bonds. The businesses of those types of institutions differ fundamentally and a one-template-fits-all approach is more than likely to be off the mark. Furthermore we find it problematic that the Discussion Paper is issued before the Directive on Crisis Management is finalised because it can create inconsistence between the Directive and the future guideline from EBA.

The Danish covered bond system[1] does already have an effective crisis management regime governed by national legislation. One of the key features of the Danish covered bond system is that the debt does not accelerate in the event of the default of the mortgage lender. The plan for the wind down of a mortgage bank is, as mentioned earlier, governed thoroughly by national law and is not dependant on any kind of taxpayer bail-out or other intervention with governmental funds. That is only achievable because the mortgage system is structured around ring-fenced, bankruptcy-remote cover pools that offer very high statutory (over-)collateral for bonds and is based on match-funded lending.

The existence of this system is crucial to investor confidence, covered bond ratings and consequently to the prices of loans funded by covered bonds. Further, it is not possible for Danish Mortgage Banks to take deposits, so there is no need for recovery plans to secure

[1] A brief introduction to the Danish Mortgage model is attached to this document as Appendix A

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deposits. This is very different from credit institutions 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, and therefore there is a need for recovery plans.

We welcome that EBA wants to ensure a level playing field and ensure harmonization as regards to recovery templates, but EBA has to take into consideration that the goal for the templates is not reached with only one template covering all types of financial institutions in Europe. Therefore we suggest that recovery plans should only apply to financial institutions, which do not in their national legislations have a sufficient framework and it must be the national authorities who decides the need for recovery plans.

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We would be pleased to elaborate on our comments, if so requested.

Yours sincerely

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Appendix

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 more than130% 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 2,400bn (about EUR 322bn), which means that the average mortgage loan per Danish citizen is DKK 415,000 (about EUR 55,500). The outstanding amount of bank loans is only DKK 1,277bn[2] (about EUR 171bn).

[2] Cf Danmarks Nationalbank, Monetary Review , 2nd. Quarter 2012

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.

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 overcollateralisation 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 overcollateralisation (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.