Realkreditrådet
ASSOCIATION OF DANISH MORTGAGE BANKS

FINANSRÅDET

REALKREDIT FORENINGEN

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European Commission
Directorate-General for Financial Stability,
Financial Services and Capital Markets Union

DG FISMA Consultation Paper on Further Considerations for the Implementation of the NSFR in the EU

Consultation response to the DG FISMA consultation on NSFR

The Association of Danish Mortgage Banks (Realkreditrådet)[1], the Danish Bankers Association (Finansrådet)[2] and the Danish Mortgage Banks' Federation (Realkreditforeningen)[3] acknowledge the introduction of a long-term structural liquidity measure based on business-as-usual assumptions in the EU. We highly appreciate the European Commission's consultation on this subject, with the aim of ensuring that the Basel III Net Stable Funding Ratio framework (B-NSFR) will not induce unexpected - and unwarranted - effects for subsets of the diverse landscape of the European financial business models.

We agree with the conclusions in the EBA report on Net Stable Funding Requirements (EBA NSFR report)[4], according to which pass-through models, financing a significant part of housing and commercial lending in the EU, must be duly recognised in the NSFR.

Danish mortgage banks operate by such a low risk and low interest-rate, pass-through business model with a "Balance Principle" which effectively removes market risk and liquidity risk[5]. In addition, Danish mortgage banks are prohibited from deposit taking and are, therefore, not subject to bank run risk. Hence, the Danish specialised mortgage model could be seen as a blueprint of a stable funding mechanism.

Unfortunately, the Danish mortgage banks will be hit even harder, than generic pass-through mortgage models, due to the additional risk mitigating properties described before, if the B-NSFR is implemented into EU rules without adjustments to the EU specificities with direct impact on housing and commercial financing. Therefore, we encourage the European Commission to take into account the issues and suggestions addressed below - anchoring the stable funding mind set within the European Union whilst, at the same time,

[1] Association of Danish Mortgage Banks, EU Transparency Register no: 27545731905-17
[2] Danish Bankers Association, EU Transparency Register no: 20705158207-35
[3] The Danish Mortgage Banks' Federation, EU Transparency Register no: 457795715324-21
[4] "EBA Report on Net Stable Funding Requirements under article 510 of the CRR", December 2015.
[5] This assessment is in line with the IMF DK Financial System Stability Assessment 2014, IMF Country Report No. 14/336, see box 2 at page 17. Observations made by the IMF regarding refinancing risk have been addressed by the MCI's and the DK FSA.

preserving the diverse landscape of financial business models, in favour of economic growth and prosperity. In our opinion the following adjustments, in combination, effectively would align incentives and create a level playing field for pass-through models, including the particularly secure Danish mortgage bank model:

- Pass-through (match funded) models like mortgage lending funded by covered bonds based on a Balance Principle, effectively eliminating market or liquidity (refinancing and funding) risks from the loan/funding portfolio, should be acknowledged as "interdependent assets and liabilities" - meaning that the mortgage lending and issued covered bonds receive 0% RSF- and ASF factors respectively. This is also in line with recommendation 6 in the EBA NSFR report.

- Funding instruments (i.e. bonds) with a legal maturity of more than 1 year and instruments shorter than 1 year, but with a statutory non-discretionary trigger for maturity extension beyond 1 year in the event that refinancing is not possible, should be considered stable funding. The Danish "Refinancing Act" applicable to all Danish covered bonds where the loan is longer than the maturity of the bonds funding the loan, is an example of such a non-discretionary trigger.

- Consequently, in pass through (match funded) models, long term mortgage lending financed by covered bonds with a maturity shorter than 1 year, but with a statutory non discretionary trigger for maturity extension beyond 1 year in the event that refinancing is not possible, also should be considered "interdependent assets and liabilities" and therefore receive 0% RSF and ASF factors respectively. Especially, if ultimately the maturity can be extended throughout the entire lifetime of the underlying loans.

- Unencumbered UCITS and CRR compliant high quality covered bonds should resemble other high quality assets, such as government bonds, with respect to the low level of RSF - and also without issue size requirements.

- Over collateralisation (OC) in covered bond cover pools should be considered unencumbered, as the assets are fully able to generate liquidity either through outright sale or repo arrangements. Aligning the definition of unencumbrance in the NSFR with the definition of unencumbrance in the LCR Delegated Act seems appropriate.

- The NSFR should be applied on both a consolidated and individual basis. We suggest that an approach based on waivers and intergroup preferential treatment for the individual requirements of the banks forming part of a group or affiliated to a central body should be considered.

Our suggestions are further described in the subsequent chapters and in annex 1. In order to help this process, we list our answers to the Commission’s consultation below.

Potential adjustments resulting from complying with the NSFR

1. *In light of previous consultations, could you describe more specifically, if appropriate, the specific activities, transactions and business models where you have evidence that the implementation of the NSFR could have an excessive impact or important unintended consequences?*

In Denmark, more than 60 per cent of domestic lending to companies and households is based on covered bonds and issued by specialised mortgage banks adhering to the Danish mortgage model. The Danish mortgage model substantially differs from a universal banking model - also in a NSFR context.

Danish mortgage banks are not allowed to take deposits. Mortgage lending is match-funded and solely based on issuing covered bonds. The covered bonds are irrevocable and, at the same time, fully interdependent with the issued mortgage loans through balance of payment requirements on a pass-through basis (The Balance Principle). Thus, mortgage loans are only granted with terms and conditions closely balancing the covered bonds issued (match-funding) and sold in the primary market on a daily basis (tap-issuance).

Due to the pass-through business model along with a strong legal and regulatory foundation, it can be shown that:

- Even portfolios with maturity mismatch are fully stable funded - either by refinancing or by one- or successive maturity extensions of the covered bonds currently funding the loans.
- Structural subordination due to asset encumbrance is not a problem in Danish mortgage banks. There are no depositors, and other creditors are fully aware that they rank junior to the covered bonds, due to the fact that all assets are part of the covered bond cover pool at all times.

See annex 2 for a detailed description of the Danish mortgage model.

The B-NSFR approach penalises specialized covered bonds issuers

Albeit, resembling a blueprint of a stable funding mechanism, Danish mortgage banks always will be short of - or just compliant in relation to - the requirement for stable funding in a B-NSFR-context.

Hence, Danish mortgage banks will need to raise additional funds, with the sole purpose to comply with B-NSFR, even though by design they are fully stable because of the balanced funding strategy. Even in cases where additional funds are raised, NSFR compliance is challenged if OC in the cover pool has to be treated as encumbered (further elaborated under question 2).

As an additional layer of inconsistencies, many business models, which are often less stable funded and less secure, e.g. mortgage lending funded by interbank funding or deposits, will always be in excess of stable funding in a B-NSFR context.

For example, in B-NSFR, it is assumed that retail- and SME deposits - for maturities below 1 year - is in a class of its own, concerning the ability to provide stable funding.[6]

The EBA NSFR report highlights an example[7] illustrating the inherent net stable funding deficit for pass-through financing models, and states that*"...Adjusting towards compliance would be very difficult and entail increasing the level of capital significantly in order to meet the NSFR requirement even in cases where such capital levels are not necessary in light of other risks and capital requirements."* and *"Given the limited strategies available for the non-compliant pass-through banks to cover their NSFR shortfall, it is expected that the funding costs for these banks will increase significantly. This could, in the end, affect the price of residential financing for the end consumers of these pass through banks."*[8]

Asset encumbrance concerns lead to an uneven playing-field

Due to the fear of structural subordination of depositors, it is a widespread belief that excessive encumbrance can be counterproductive or even devastating to universal banks.

The B-NSRF framework seems to seek to mitigate the risk of excessive encumbrance, by applying an overly harsh treatment of funding through encumbrance.

Specialized pass-through mortgage lending institutions, such as Danish mortgage banks, which are not exposed to the risk of structural subordination given that they are not allowed to take deposits, are significantly impacted by the harsh RSF requirements on encumbered assets. Danish mortgage banks are only allowed to issue loans against covered bonds funding and are not allowed to take deposits. Consequently, the entire loan-portfolio of a Danish mortgage bank is fully encumbered.

The harsh treatment of covered bond funded mortgage lending severely hampers the level playing-field in favour of unsecured funding. As illustrated in our answer to question 2, banks funded only with unsecured funding, will be allowed under the B-NSFR to have multiple times more short term funding than institutions only funded by covered bonds.

This is emphasised in the EBA NSFR report stating that: *"...In comparison, if mortgage loans are funded by senior unsecured funding they are not encumbered and thus receive lower RSF factors (65% for residential mortgages), resulting in a higher NSFR level for the*

[6] Private- and SME deposits are assigned an ASF of 90-95 pct. for maturities less than 1 year compared to i.e. covered bonds and/or loans from central banks which are assigned ASF's of 50 pct for maturities between ½ to 1 year and 0 pct. for maturities less than half a year.
[7] EBA NSFR report Annex 11
[8] EBA NSFR report page 136 and 140.

bank. In this context, one must assume that banks will, to some extend, be disincentivised to use covered bond funding."[9]

Over collateral in Danish mortgage banks are -in a liquidity sense- unencumbered

For Danish mortgage banks, the cover pools consist of mortgage loans funded by covered bonds and over collateral (OC) - defined as other assets on the balance sheet - which is funded by equity and other capital and debt instruments ranking junior to covered bonds.

In Denmark, the bankruptcy privilege of covered bond investors includes all assets on the balance sheet of the mortgage bank. Thus, regulatory capital (as spelled out in CRR/CRD IV) also must be allocated to the cover pools of Danish mortgage banks. Consequently, OC in a cover pool of a Danish mortgage bank, by law, is made up of both assets funded by regulatory capital as well as other assets funded by other capital and debt instruments. The OC supports different requirements for credit enhancement - typically regulatory minimum requirements or specific requirements from rating agencies in order to support a specific rating of the covered bonds. Typically, the mortgage bank operates with assets in excess of those requirements. However, since the requirements are parallel, it is not simple to distinguish between mandatory or voluntary OC.

The OC is done without asset encumbrance concerns because:

- Danish specialised mortgage banks are non-deposit taking banks. Thus, no simple depositors will ever suffer from further credit enhancement of the issued covered bonds.

- It is the common understanding - due to the simple and statutory balance sheet structure and high transparency - of all creditors of a Danish mortgage bank, that they rank junior to the covered bonds investors. In return, they receive a yield pick-up relative to covered bonds.

- There is no link between the assets constituting as over collateral and the instruments funding those assets. Thus, an "encumbrance penalty" - as an independent incentive to mitigate "excessive encumbrance" - can't be justified in any sense concerning Danish mortgage banks.

Assets held for credit enhancement purposes in a cover pool (regulatory or rating requirements) should not be mistaken and identified as encumbered assets in a liquidity framework. While the OC is encumbered in a solvency perspective, the purpose of those assets is exactly to be used to generate liquidity either through outright sale or for instance through repo transactions when needed.

[9] EBA NSFR report page 173.

This view is supported by the fact that both rating agencies and the CRR/CRD IV/LCR acknowledge assets held for rating requirements and capital requirements in the cover pools of Danish mortgage banks as assets available for liquidation (which is also in line with the fact that neither rating agencies nor the CRR/CRD IV differentiates with respect to the funding of the OC). Based on these facts, OC in pass-through cover pools in a Danish non-deposit taking specialised mortgage bank explicitly should be recognised as unencumbered assets in the NSFR.

Failure to recognise OC in pass-through cover pools as unencumbered assets in a liquidity sense would lead to a penalising level of stable funding requirement for the rather broad composition of OC in Danish mortgage banks.

In detail, it would be much more expensive for Danish mortgage banks to credit enhance the loan portfolio in relation to institutions (i.e. universal banks) allowed to hold assets outside the cover pool(s). This is because the assets applied to credit enhancement purposes in a Danish mortgage bank would be defined as encumbered, since they must be allocated to a cover pool.

Furthermore, if OC has to be treated as encumbered, it would not improve NSFR if institutions issued CET1 capital (the most stable funding source with ASF = 100%) and bought highly liquid government bonds with a maturity longer than 1 year, as that would require 100% stable funding. If, on the other hand, the government bond is shorter than 1 year, it might require less than 100% stable funding (as we understand it), and thereby can improve NSFR. Ultimately, the bond expires and turns into cash and requires no stable funding – unless it is still considered encumbered and requires 100% stable funding, meaning that it can't improve NSFR. If, on the other hand, the cash is treated as unencumbered (and RSF = 0), it is highly inconsistent, that OC consisting of securities with a maturity larger than 0 should be treated as encumbered. The point is that, OC doesn't become unencumbered as the maturity goes towards 0 – OC is unencumbered all the time.

Finally, the LCR Delegated Act has a definition of unencumbered assets as part of the liquidity definition. In order to ensure consistency in the liquidity regulation it seems appropriate to replicate – or simply to make a reference to the LCR Delegated Act – the definition of unencumbered assets in the NSFR. Assets that are classified as unencumbered under the LCR should also be classified as unencumbered under the NSFR.

The high credit quality of Danish covered bonds should be acknowledged

NSFR is a structural liquidity risk metric covering the 1 year horizon rather than a stress liquidity metric like the LCR. Consequently, the NSFR liquidity value of assets, traded in large and deep markets, should depend on the credit quality of the asset. This perspective is also endorsed in the EBA NSFR report stating that: *"The NSFR has a "business as usual" background in its conception but it ultimately also contributes to minimising the probability of liquidity and funding stress situations as well as their intensity. It is, therefore* *a **structural liquidity metric** rather than a stress liquidity metric...Therefore, there is scope to aggregate items that behave in the same way under normal conditions."*[10]

In this context, assets, which under normal conditions behave as high credit quality assets, should be treated the same way in NSFR. Specifically, covered bonds with high credit quality should be assigned the same required stable funding factors as other high credit quality assets (e.g. government bonds). There is no good reason for assuming higher haircuts (RSF factors) on high quality covered bonds in a normal situation - *especially,* when, at the same time, there is no differentiation due to maturity.

Empirical evidence confirms that Danish covered bonds - irrespectively of issuance size - were as liquid as most European government bonds before -, during - and after the financial crisis[11]. Hence, the RSF of high quality covered bonds also should be independent of issue size - further resembling the treatment of government bonds in both the NSFR and LCR frameworks. No evidence calls for differentiated treatment according to issue size in a "business as usual" scenario.

Failure to recognise the irrelevancy of issue size in determining the RSF factor for high rated covered bonds could have detrimental consequences. For example, if the reliance on issuance size is transported from LCR to the NSFR approach would have severe consequences. In this scenario, large covered bonds series with an outstanding volume larger than EUR 500m from a cover pool having credit quality step 1 (extremely high quality covered bonds) would probably receive a RSF factor of 5%, while smaller covered bonds series from the same cover pool (hence having the same credit quality) would receive a RSF of 85% if the issue is smaller than EUR 250 m (non-HQLA)[12] – i.e. requiring 17 times as much stable funding when investing in issues less than EUR 250 m - even if the bonds are issued from the same cover pool. This calibration is not based on evidence and could have devastating price and demand effects for the bonds, meaning that it can become very difficult to compete for new and smaller institutions as their bonds should be considered almost worthless when liquidated in NSFR.

In addition, residential mortgage loans (being very illiquid) would be considered more liquid than corresponding extremely high quality covered bond, which has funded the mortgage loans, in case the issue size does not exceed EUR 250m (RSF factor for residential mortgage loans is 65 % compared to 85% for issues smaller than EUR 250m).

[10] EBA NSFR report page 33.
[11] Dick-Nielsen, Jens and Gyntelberg, Jacob and Lund, Jesper, Safe and Liquid Mortgage Bonds: Evidence from the Danish Housing Crash of 2008 (December 22, 2015).
[12] In LCR DA, covered bonds with an issue size smaller than EUR 250 m do not qualify as liquid assets (i.e. they are not included in the definition of level 1 and 2 assets in chapter 2 in LCR DA) - irrespective of AAA ratings. Consequently, such covered bonds are treated as non-liquid assets in B-NSFR with a corresponding RSF of 85%.

The Danish mortgage banks, traditionally, build up covered bond series gradually by daily tap issuance corresponding to the daily loan activity. This, in combination with the very high degree of transparency, has always been the backbone of the Danish system.

The match funding and tap issuing of Danish mortgage banks, means that pipeline, funding, market and liquidity risks are eliminated. This is challenged, if investors are disincentivised in NSFR to buy smaller issues.

Conversely, it takes time, in particular for smaller Danish mortgage banks, to build up the covered bond series - which would make such institutions especially exposed to potential introduction of an issue size requirement in a European implementation of NSFR.

Therefore, the very high credit quality of Danish covered bonds should be acknowledged by assigning low required stable funding factors to all series of highly rated Danish covered bonds. The key factor for haircuts is the credit quality of the asset.

2. *If a respondent is a bank, could you please quantify the level of your expected shortfall of stable funding, the changes to the composition of your balance sheet that may result from meeting the NSFR and what the impact of these changes may be on the European economy?*

The detrimental consequence of the negatively biased calibration of the B-NSFR vis a vis specialized mortgage banks (having covered bonds as the only funding instrument) can be illustrated in a simple example (please see the table below). The bank has a total balance of 100bn, where the assets consists of 95bn residential mortgages (maturity > 1 year) and 5bn level 1 assets, rep-resenting 5bn over collateral (OC) funded with different capital types (maturity > 1 year).

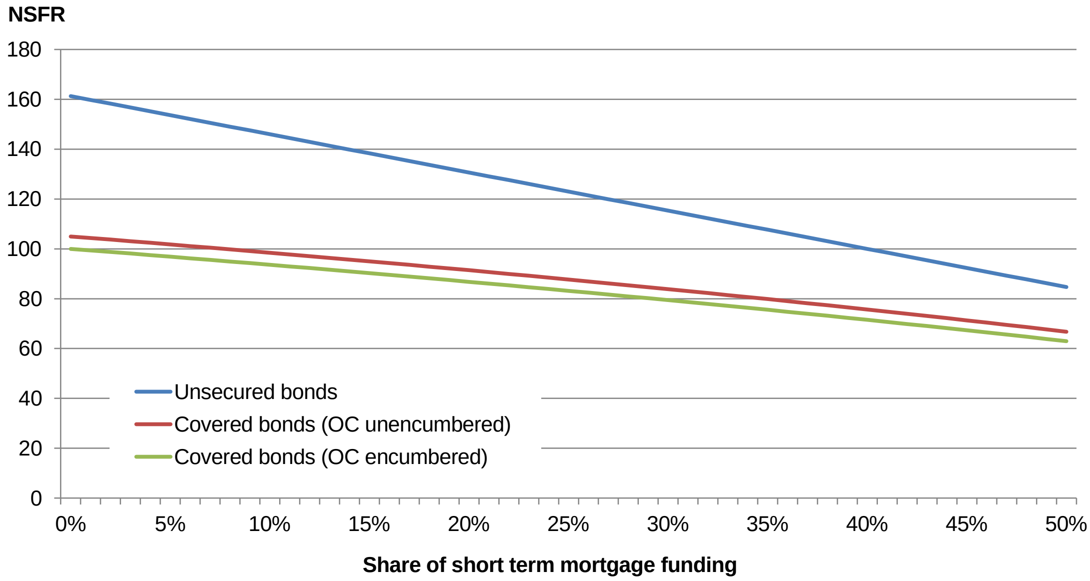
Assets		**RSF**				**Liabilities**		**ASF**
		Unsecured bonds	**Covered bonds (OC unencumbered)**	**Covered bonds (OC encumbered)**				
Level 1 assets (OC)	5	5%	5%	100%		Capital > 1Y (OC)	5	100%
Residential mortgages > 1Y	87	65%	100%	100%		Bonds > 1Y	87	100%
Residential mortgages > 1Y	8	65%	65%	65%		Bonds < 0.5Y	8	0%
Total (weighted)	**100**	**62**	**92**	**97**		**Total (weighted)**	**100**	**92**
NSFR		**148**	**100**	**95**				

Mortgages are funded with bonds. In one scenario, the bonds are senior unsecured and in the other scenario, they are covered bonds. 8bn of the bonds (app. 5%) are short term with a maturity shorter than ½ year (ASF=0%). The rest of 87bn have a maturity longer than 1 year and are therefore considered 100% stable funding (ASF=100%). Mortgages funded with short term covered bonds can be considered unencumbered.

Although the maturity profile of the funding is exactly the same, the B-NSFR concludes, that unsecured bond funding is a stable funding strategy with NSFR of 148% well above the 100% threshold, whereas covered bond funding is just NSFR compliant and without any buffer (NSFR = 100%) – but only if OC is considered unencumbered. If OC in covered bond cover pools is considered encumbered with a RSF of 100%, NSFR further drops to 95%!

The unsecured bonds-only mortgage bank can actually fund up to 40% of the mortgage portfolio with short termed bonds (< 0.5 year) and still be NSFR compliant. This is shown in the graph below using the same example, but with different assumptions regarding the share of short term (< 0.5 year) and long term (> 1 year) bond funding. The covered bond-only mortgage bank can not at all fund the mortgage portfolio with short termed bonds, if OC is considered encumbered (NSFR<100%). If OC is considered unencumbered, only up to 8% can be funded with short term bonds in order to be NSFR compliant (NSFR≥100%).

Consequently, even if OC is considered unencumbered, an unsecured bonds-only strategy is allowed to have 5 times as much short term funding as a covered bonds-only strategy.



The result, of that an unsecured-only funding strategy should be more stable than a covered bond-only funding strategy, is counter intuitive (and unwarranted), as covered bonds showed greater liquidity and less volatility than senior unsecured funding during the financial crisis. Furthermore, it is hard to understand, why unsecured bond-only banks should be allowed to have significantly more (in this example, 5 times more) short termed funding than covered bonds-only banks. The Basel Committee's logic behind this is that the assets of unsecured bond-only banks are unencumbered and therefore can be monetised through outright sale or collateralized repo transactions. This should give these banks a larger new funding capacity.

It is questionable; however, if this argument justifies the ability to refinance 5 times as much short term funding. If a crisis hits the financial system this might be possible, but probably only if the institution uses secured funding instruments like covered bonds, as the recent financial crisis proved, that it could be very difficult to issue unsecured funding during periods of market stress. In this perspective, it is paradoxical, that the larger short term funding capacity is assumed for institutions not using the covered bond instrument.

Therefore, it suggests a second look at the calibration of the NSFR regarding the treatment of covered bonds funding that proved robust during the financial crisis. This second look should also consider level playing field perspectives between different business models.

Application of the proportionality principle

8. *What do you believe the appropriate level of application of the NSFR to be? Is there scope to make the NSFR requirements more proportionate and, if so, on the basis of what criteria?*

Since most of the balance of non-deposit taking pass-through business models primarily should be exempted from the NSFR-calculation due to the fact that they are interconnected assets and liabilities, it would be appropriate - not least from a proportionality perspective - to explicitly state that the assets and liabilities of non-deposit taking pass-through business models are acknowledged as "interdependent assets and liabilities" - meaning that the lending and financing of such business models receive 0 % RSF- and ASF factors respectively. In our view non-deposit taking pass-through business models qualifying for the proportionate treatment should resemble specialised mortgage banks and therefore could be defined as follows:

"A specialised mortgage bank is a credit institution as defined by the CRR whose primary activity is mortgage lending financed only by issuing covered bonds and where, according to national law,

a. the institution is not allowed to receive deposits,

b. the issued covered bonds must comply with bonds referred to in UCITS 52(4),

c. the exposures must comply with the framework of CRR 129 at time of origination or first inception in a cover pool, and

d. the institution will be wound-up through national insolvency procedures, or other types of procedures implemented in accordance with Articles 38, 40 or 42 of the Bank Recovery and Resolution Directive (BRRD), provided for such institutions which will ensure that creditors of such institutions, including holders of covered bonds where relevant, will bear losses in a way that meets the resolution objectives."

The above definition, and based on Article 45, Point 3 of Directive 2014/59/EU (15 May 2014) on establishing a framework for the recovery and resolution of credit institutions and investment firms (BRRD).

9. *In particular, what criteria could be used to define institutions with a "low liquidity risk profile"? What simplified metrics (e.g. core funding ratio close to loans to deposits + capital) could be used to identify these institutions? Should certain institutions be completely exempted from the NSFR and on what basis?*

As described previously, pass-through (match funded) models like mortgage lending funded by covered bonds based on a Balance Principle, effectively eliminates market- or liquidity (refinancing and funding) risks from the loan/funding portfolio.

As further described, specialised mortgage banks are a modulation of such a pass-through model further including ban on taking deposits and issuing any other products than mortgages. Thus, specialised mortgage banks, such as Danish mortgage banks, are low risk business models with no inherent risk of structural subordination or risk of institutes using the cheap covered bond financing within the cover pool for issuing/financing high(er) risk loans/products.

Therefore, specialised mortgage banks, subject to a regulatory Balance Principle with interdependent in- and outflows on the mortgage lending, should be defined as an institution with a low liquidity risk profile.

The definition of specialised non-deposit taking mortgage banks, subject to a regulatory Balance Principle with interdependent in- and outflows on the mortgage lending, could be defined in the following way:

"A specialised mortgage bank is a credit institution as defined by the CRR whose primary activity is mortgage lending financed only by issuing covered bonds and where, according to national law,

- a. *the institution is not allowed to receive deposits,*
- b. *the issued covered bonds must comply with bonds referred to in UCITS 52(4),*
- c. *the exposures must comply with the framework of CRR 129 at time of origination or first inception in a cover pool, and*
- d. *the institution will be wound-up through national insolvency procedures, or other types of procedures implemented in accordance with Articles 38, 40 or 42 of the Bank Recovery and Resolution Directive (BRRD), provided for such institutions which will ensure that creditors of such institutions, including holders of covered bonds where relevant, will bear losses in a way that meets the resolution objectives."*

The above definition, and based on Article 45, Point 3 of Directive 2014/59/EU (15 May 2014) on establishing a framework for the recovery and resolution of credit institutions and investment firms (BRRD).

Concluding remarks

In our view, it is of utmost importance that the flaws of the B-NSFR model, highlighted in this position paper, are considered when drafting the new EU rules on this measure. It would be very helpful, if the European Commission would consider either a recalibration and/or amendment of the B-NSFR framework when implementing it into EU-law. Lastly, it might otherwise hopefully be considered to mitigate the devastating effects of B-NSFR to Danish mortgage banks and similar institutions.

We hope that the proposed amendments to the B-NSFR framework presented in this position paper would be able to mitigate the general flaws of the B-NSFR framework. Hopefully our proposals can serve as inspiration for the journey towards an implementation of a Net Stable Funding ratio in the EU, in a manner fostering economic growth and jobs due to an effective flow of stable funding financing the real economy.

Kind regards,

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Annex 1:

Detailed description of suggestions mitigating the shortcomings of the B-NSFR

Interdependent assets and liabilities

According to paragraph 45 in the B-NSFR, national supervisors can set the RSF and ASF to zero for assets and liabilities which are identified to be interdependent, where interdependence, amongst other requirements, are defined by identical remaining time-to-maturity of the asset and the liability.

In Denmark, statutory caps on payment imbalances on mortgage lending (cover assets) and covered bonds (i.e. Balance Principle) apply. Payments from cover assets, therefore, balance payments of interest and principal on covered bonds. In addition, the interdependency of cover assets and covered bonds is further supported by the application of the match funding business model in Danish mortgage banks effectively eliminating payment imbalances on cover assets and covered bonds, i.e. the mortgage bank is acting solely as a pass-through unit. This outcome also holds for Danish adjustable rate mortgages (ARMs) due to the introduction of the Danish Refinancing Act, as described in the subsequent section.

As a consequence, we find that paragraph 45 of B-NSFR, comprises cover assets and covered bonds held/issued by Danish mortgage banks, where the remaining time-to-maturity of the cover assets and covered bonds are identical.

This is in line with the recommendation no. 6 of the EBA NSFR report, which states that: *"The treatment of interdependent assets and liabilities, as envisaged in the Basel standard (as in paragraph 45), is recommended in the case of fully matched funded amortised mortgage lending."*[13]

Therefore, we recommend that cover assets and covered bonds with the characteristics outlined above - directly - are excluded in the calculation of the NSFR-ratio.

Statutory options effectively matching the maturity of assets and liabilities

In a stable funding context, the level of discretion to options on adjustments of the remaining time to maturity of an underlying funding instrument is pivotal. If the issuer has the discretion to trigger an option to change the maturity of an underlying funding instrument, it is to a large extend, a behavioural condition which can make it difficult to assess whether or not it will actually mitigate the funding risk (i.e. other concerns such as image of the issuing institution might carry a higher weight than the concerns for stable funding). Therefore, B-

[13] EBA NSFR report page 20.

NSFR provides specific guidelines on the treatment of funding instruments with built-in discretionary options.

Conversely, non-discretionary options automatically triggered by predefined events are fully predictable given the predefined events materialises. Therefore, there is no assumed issuer behaviour on funding instruments with non-discretionary options in B-NSFR.

Generally, funding instruments should be treated as long term funding, if the maturity is more than 1 year, or non-discretionary options secure, the effective maturity of the instrument is more than 1 year in case the instrument cannot be refinanced beyond the 1 year horizon. In other words, the built-in option is an implicit guarantee of funding beyond the 1 year horizon in all scenarios - without reliance on discretionary decisions by the issuer (maturity extension).

Unlike generic short-term covered bonds financing adjustable rate mortgages, Danish short-term covered bonds financing ARMs, since April 2014 and due to the Danish Refinancing Act, have been issued with a legal statutory option to extend the maturity of the covered bond in case the issuer is unable to refinance the ARMs (please see Annex 2). The option is not exercisable at the discretion of the issuer, but it is conditional on the specific market event of “no refinancing”. The maturity of the covered bond is extended “automatically”, so that ARMs are funded in all scenarios - on a "going concern" basis.

Ultimately, this statutory option results in a perfect match in the maturity of the covered bond, and the ARM. This is the case if conditions for refinancing of the ARM should never occur (if the option triggers are met at each refinancing point). In this instance, the maturity of the covered bond is therefore extended continuously, until the end of maturity of the ARM itself.

Therefore, Danish covered bonds funding Danish ARMs should be considered as stable funding.

Consequently, we would encourage, that funding with non-discretionary statutory options to extend maturity and the underlying lending are acknowledged - specifically in the regulation - as interdependent assets and liabilities, which are qualifying for the preferential treatment under paragraph 45 of B-NSFR.

In the EBA NSFR report, the Danish Refinancing Act is described and duly recognized for effectively securing stable funding of Danish ARMs: *"Under these legal safeguards, the bonds are behaviourally long term from a funding perspective as the legislation stipulates an automatic rollover during one year if the market does not refinance them."*[14]

[14] EBA NSFR report page 140.

Low RSF factor for all high quality covered bonds

With the decision taken by the European Commission in its Delegated Act on the Liquidity Coverage Requirement (LCR DA) [15], the European transposition of the Basel III Liquidity Coverage Ratio was amended to accommodate the unique characteristics of the EU covered bond market.

Similarly, it would be very helpful, if the European Commission, in their considerations on the transposition of the B-NSFR framework would rightfully accommodate the high credit quality and liquidity of European covered bonds.[16]

As mentioned in our general comments, high quality unencumbered covered bonds, such as the most highly rated Danish covered bonds, in a NSFR-framework, should be treated as if they can be traded close to their market value. In our view, a rightful treatment would imply that covered bonds should be assigned a RSF close to 0% (specifically 5% as government bonds).

Level of application

Due to the sheer scope of regulatory initiatives in the wake of the financial crisis, keeping inconsistencies between pieces of regulation to a minimum has become a separate objective.

Therefore, we would appreciate if the application of NSFR where to follow the general approach to liquidity envisaged in the CRR, where the NSFR should be applied on both a consolidated and individual basis, in which case an approach based on waivers and intergroup preferential treatment for the individual requirements of the banks forming part of a group or affiliated to a central body should be considered.

[15] Delegated Regulation EU No 2015/61 of 10 October 2014

Annex 2

The Danish Mortgage Model

This section gives an overview of the primary properties of the Danish mortgage model.

Danish specialised mortgage banks (Danish mortgage banks) are a special type of institutions falling under the definition of "specialised credit institutions" as identified in the report of the European Banking Authority (EBA) on EU covered bond frameworks and capital treatment.[17]

Danish mortgage banks, are prohibited from taking deposit and mortgage lending is funded only by issuing covered bonds.

In effect, Danish mortgage banks are institutions based on "match-funding" in line with the definition in the EBA report on Net Stable Funding Requirements (EBA NSFR report)[18]. In this report, "match-funding" is defined as a special case of a general pass-through funding principle, were the cash flows from the borrower to the covered bond investor are interdependent, *also* in the case of premature redemption of the mortgage loan.

Thus, Danish match-funded mortgage loans are funded by covered bonds which are irreversible on the investor side and at the same time fully interdependent with the bonds, should the borrower choose to redeem the loan prematurely.

Consequently, Danish match-funded mortgage loans are fully stable funded.

Danish mortgage banks also offer adjustable-rate mortgages (ARMs) in the form of sequential match-funded mortgages, as defined in the EBA NSFR report.[19] In 2014 the Danish Parliament implemented a "Refinancing Act"[20], effectively removing the potential refinancing risk of such loans.

The act applies to covered bonds (SDROs, SDOs and ROs) issued by mortgage banks and commercial banks where the loan term is longer than the maturity of the bonds funding the loan. If a mortgage bank is unable to sell the bonds offered before the maturing bonds mature, the bonds will be extended by 1 year at a time until there are takers for all the necessary bonds. Maturity extension for 1 year at a time is required for mortgage banks in going concern and commercial banks in liquidation.

[17] "EBA Report on EU Covered Bond Frameworks and Capital Treatment", EBA, July 2014
[18] "EBA Report on Net Stable Funding Requirements under article 510 of the CRR" December 2015.
[19] EBA NSFR report page 133.
[20] Act No. 89 of 11 March 2014 to Amend the Act on Mortgage-Credit Loans and Mortgage-Credit Bonds, etc. and the Financial Business Act (Regulation of the refinancing risk inherent in mortgage-credit bonds, covered mortgage-credit bonds and covered bonds, etc.)

Ultimately, the Refinancing Act matches the payment streams and duration of the loan and covered bond, through a successive extension of the maturity of the covered bond which is funding the loan.

In effect, ARMs funded by Danish covered bonds also are fully stable funded - either by refinancing or by one- or successive maturity extensions of the covered bonds currently funding the loans.

Danish covered bonds issued by Danish mortgage banks are especially secure since the bankruptcy privilege of covered bond investors includes all assets on the balance sheet of specialised credit institutions.

As credit institutions, specialised institutions must comply with the capital and liquidity coverage requirements of the Capital Requirement Regulation.

With the balance sheet structure of a specialised bank, this means that any increase in risk on cover assets entails an increase in over collateralisation in support of the covered bond issued. Capital and liquidity coverage requirements work as a ‘transmission mechanism’.

This is done without asset encumbrance concerns since the mortgage banks don´t have any depositors. Due to the simple balance sheet structure and high transparency, it is of perfectly clear understanding of all other creditors of a specialised institution that they legally rank junior to the covered bonds investors as all assets are part of the covered bond cover pool at all times. In other words, those creditors are aware of the structural subordination in a gone concern situation and are able to price that risk ("consenting adults").

Therefore, structural subordination due to asset encumbrance is not a problem in Danish mortgage banks.

Danish mortgage banks are tap issuing covered bonds every day and have no problems selling issues smaller than the level 2A criteria of EUR 250m in the LCR DA. In addition, the secondary market for Danish covered bonds is large and deep. Thus, Danish covered bonds, both historically and today, are highly liquid irrespective of issue sizes and time to maturity. A recent study firmly states, that Danish covered bonds - irrespective of issue size - were equally as liquid as most European government bonds before, during and after the financial crisis.[21]

Thus, Danish covered bonds are documented to be highly liquid assets irrespective of issue size - even under stressed conditions.

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[21] Dick-Nielsen, Jens and Gyntelberg, Jacob and Lund, Jesper, Safe and Liquid Mortgage Bonds: Evidence from the Danish Housing Crash of 2008 (December 22, 2015).