Association of Danish Mortgage Banks

Annual report 2015/16

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Association of Danish Mortgage Banks – profile

The Association of Danish Mortgage Banks solely represents financial undertakings which are subject to Danish legislation and supervision and which use Danish covered bonds (”Særligt Dækkede Obligationer” – SDOs, ”Særligt Dækkede RealkreditObligationer – SDROs, and ”Realkreditobligationer” – ROs) to fund lending against mortgages on real estate.

As of 1 January 2016, the members of the Association are: BRFkredit a/s, DLR Kredit A/S, Nykredit Realkredit A/S and Totalkredit A/S.

The members of the Association of Danish Mortgage Banks represent nearly 57% of the total bond debt outstanding issued by Danish mortgage banks (end-2015).

On behalf of our members, the Association of Danish Mortgage Banks strives to gain:

- Influence on the preparation and interpretation of legislation in Denmark and the EU to promote the interests and market position of the Danish mortgage industry, including as a minimum to ensure a level playing field for the mortgage system
- A strong voice in the public debate
- An overview of and insight into trends and changes in international legislation.

The Association of Danish Mortgage Banks works to maintain and develop a mortgage system which is characterised by its balance principle and transparency of prices and products, and which offers a flexible and market-based prepayment system.

It is our firm belief that the Danish mortgage model provides:

- Low and competitive prices of loans backed by mortgages on real estate
- Transparency of loan rates and prepayment terms
- Accessible funding on market terms for all people owning real estate
- Financial stability.

Chairman's statement

Mortgage banking attracted much attention in the past year. Certainly, 2016 will be remembered as a year with great frustrations about administration margin increases. The confidence and credibility of such immense value to the mortgage sector were challenged.

Obviously, we have failed to explain our unique mortgage model, and an extensive and demanding task of rebuilding confidence and trust lies ahead of us.

We must become better at communicating about mortgage loans and how they work – and this is complicated in its own right. But we should also point out why the mortgage model is challenged. We must clarify that new regulation has resulted in significantly more expensive mortgage loans. If we are to be able to continue offering unique and affordable mortgage loans to homeowners, businesses, the public housing sector and agriculture across Denmark, we have to adjust our loan rates.

We want all our customers to know how mortgage lending works as well as the reasons why the mortgage model is under pressure. This is an ambitious goal. Maybe it is even too ambitious, as we must also appreciate that not everyone has the same fervent everyday interest in mortgage lending as we have. However, this does not change the fact that we must work really hard to cover more ground than we do right now. That is the only way to restore confidence in our sector.

Moreover, the great frustrations meant that, in 2016, mortgage lending was given a thorough check-up by an expert committee appointed by the Danish Minister for Business and Growth. The outcome of the committee's work was a 119-page report, which we welcome in the Association of Danish Mortgage Banks.

The report provides a thorough and balanced introduction to Danish mortgage lending and describes the historically low profitability of mortgage lending. The report confirms that the Danish mortgage model remains transparent and favourable to borrowers. This way, the report helps disseminate knowledge about the mechanisms of Danish mortgage lending.

The report also documents the impact on the Danish mortgage sector of stricter capital requirements set out by the authorities, rating agencies and investors in the financial crisis aftermath. And the report thoroughly describes the series of new and significant requirements in the pipeline. This applies for instance to the capital floors introduced by the Basel Committee.

The report of the expert committee includes calculations by the Danish Financial Supervisory Authority (the Danish FSA), which show a need for banks and mortgage lenders to massively increase their capital by as much as DKK 117bn if the requirements are implemented. The Association of Danish Mortgage Banks, the Danish Bankers Association and the Danish Mortgage Banks' Federation came up with a correspondingly high capital requirement. It is important to emphasise that the final requirements remain unknown. Other measures than capital floors may also increase capital requirements. In any case, we must now conclude that capital floors alone are a fundamental challenge for Danish mortgage banking.

The Association of Danish Mortgage Banks wants a transparent market that is easily understood by consumers. Therefore, we support the proposals put forth in the report to improve consumer protection in the mortgage market. We have even contributed with several of the proposals ourselves. However, we recommend thoroughly considering the implications if choosing to eliminate the possibilities of mortgage banks to cover their costs.

For we are operating in a market characterised by fierce competition. More than 100 bond traders trade in covered bonds. This is a costly affair and these costs do not go away with a ban. Instead they must be paid by all the customers who choose not to refinance or switch mortgage banks. Therefore, we believe that a ban against charging trading commission and price spreads would be unfair to consumers and banks alike.

In the coming years, mortgage banks will make every effort to rebuild confidence in the sector. Greater confidence in the sector serves everyone's interest. However, to do this, the mortgage sector needs a regulatory break or – at least – assurances that new regulation will not unjustly impose more costs on Danes.

It is therefore my hope that ministers, Danish and European MPs, government officials and we from the mortgage sector are able to stand united in the struggle for future-proofing mortgage lending. On behalf of the mortgage sector, I would like to thank you for the great efforts already made.

Report on transparency and mobility in the mortgage market

The report provides a thorough introduction to Danish mortgage banking. It contributes to communicating knowledge about the mechanisms of mortgage lending. Based on the report, the expert committee has proposed several noticeable tightening measures, which will further tighten up consumer protection in Danish mortgage lending. The report also confirms that the Danish mortgage model is transparent, affordable and favourable to borrowers.

In March 2016, the Minister for Business and Growth commissioned an expert committee to review the possibilities for strengthening transparency and mobility in the mortgage market. The committee was also to present recommendations for revising mortgage lending regulations.

One of the tasks was to elucidate the consequences of the tougher capital and liquidity requirements faced by the financial sector in the wake of the financial crisis. The committee was also commissioned to describe customers' costs in connection with a change of mortgage bank and assess whether these constitute a barrier to customers' change of mortgage banks. See the complete description of the expert committee's mandate on the Danish Ministry of Business and Growth's website: https://www.evm.dk/nyheder/2016/16-03-29-ekspertudvalg-realkredit] (Only in Danish).

Together with the rest of the financial sector, the Association of Danish Mortgage Banks has made specific recommendations to further tighten up consumer protection. This could be better communication to the public about the reasons behind administration margin increases, the possibilities of switching mortgage banks, and that, in the future banks may not charge a prepayment fee, if a homeowner wishes to prepay a loan in the notice period following a price increase, as well as an extended notice period for price increases.

Overall, the report recommends imposing stricter consumer protection in Danish mortgage lending. For mortgage banks, this will require a number of adjustments resulting in a decline in income and increased IT expenses. Danish mortgage lending is already very transparent and consumer-oriented, and also one of the world's most affordable means of housing and property financing.

FAR-REACHING INTERVENTION IN A COMPETITIVE MARKET

The Association of Danish Mortgage Banks generally backs all the report's recommendations to increase the mobility, competition and flexibility of the mortgage system.

However, we cannot back the proposal to remove mortgage banks' possibilities of covering their costs of prepayments in the notice period in the form of trading costs (in the following "trading commission") and price spreads. Generally, this is a far-reaching step, which we do not think is substantiated by the committee's analyses.

Two representatives from the Danish Consumer Council and three independent members of the committee are in favour of the proposal, while the three representatives from the financial sectors are against it. Representatives from the ministries, the Danish central bank and the Confederation of Danish Industry – six representatives in total – remained neutral. In other words, a minority of 5 out of 14 members favours the proposal.

In the view of the Association of Danish Mortgage Banks and the rest of the financial sector, the proposal reflects an unnecessary interference with the pricing policies and pricing of private businesses in an open and competitive market. Trading commission and price spreads on loan prepayment reflect the costs associated with bond purchases where borrowers may alternatively choose to buy bonds in the market themselves.

The trading commission rates and price spreads charged are based on a market with many providers. Borrowers always have the option of prepaying a mortgage loan through delivery of the underlying bonds. In Denmark, more than 100 securities dealers offer quotes on how much it would cost to redeem the bonds behind a loan. It is a full-competition market.

Usually, upon termination of a contract, businesses get their costs covered or are compensated for loss of income. For example, many Danes invest their savings in investment fund certificates. Here a new investor pays the costs of entering a subfund while a seller of units pays for exiting a subfund. The other investors in a subfund thus will not have to pay for the entry and exit of other members. This is established in the statutory explanatory notes.

Terminating or changing a pension scheme is also subject to prepayment costs and trading commission. Typically, an estate agent may claim compensation for termination of an agency agreement. Under a leasing contract, the lessee is typically obliged to make lease payments for a minimum period, for example 11 months, regardless of whether or not the lessee wants to keep the lease.

Interfering with the possibilities of mortgage banks to cover the costs of prepayment has distressing perspectives for the pricing policy of businesses.

MORE EXPENSIVE FOR MOST HOMEOWNERS

The proposal exempts all homeowners wishing to refinance their loans in the notice period from trading commission and price spreads, regardless of whether they change mortgage banks or not. However, this does not eliminate the costs of bond trading. If mortgage banks are no longer permitted to cover the costs of loan prepayments through trading commission and price spreads in the notice period, the costs must instead be passed on to the customers who choose not to transfer their loans. That is not fair.

THE MORTGAGE BANKING SECTOR'S PROPOSAL

The Association of Danish Mortgage Banks has addressed the work in the expert committee in a constructive way. We and the rest of the financial sector propose allowing the transfer of housing loans that exceed the lending limit. Our proposal will motivate mortgage market mobility by enabling more borrowers to change banks, if for instance the borrower's bank raises its prices. This will also improve competitiveness in the housing loan market. The proposal will also prevent customers with high LTV ratios from being tied permanently to one specific provider, particularly customers in areas with declining property prices. However, this proposal did not obtain the backing of the committee.

The sector also suggested that customers should be exempt from paying the mortgage registration fee along with the prepayment fee, as this could be considered a tax on mobility. However, this proposal did not win majority in the committee.

MORTGAGE MODEL IS ROBUST AND TRANSPARENT

The expert committee recognises in its report that the Danish mortgage model is very transparent, low-priced and offers favourable terms for borrowers with respect to ongoing credit costs and affordable prepayment options. The expert committee also stresses the low losses incurred by the mortgage sector.

Finally, the expert committee acknowledges that, in light of stricter capital requirements and other regulation, mortgage banks have had to increase their earnings. The expert committee also emphasises that the scope for increasing earnings is essential in relation to maintaining the security of and confidence in the mortgage system, for instance in the eyes of investors and credit rating agencies.

NEW REGULATION HAS SIGNIFICANT IMPACT ON THE MORTGAGE BANKING SECTOR

The report documents that in the aftermath of the financial crisis, mortgage lending was affected by a large number of tougher capital requirements. There are also requirements from rating agencies and investors. However, a number of new requirements are in the pipeline, for example capital floors from the Basel Committee (see "Leverage and capital floor requirements challenge Danish mortgage lending").

The committee also concludes that, if the capital requirements for mortgage banks are increased to the extent reflected in documents available from the Basel Committee, administration margins may rise further in the coming years.

Recommendations by the expert committee

With regard to increased mobility and transparency, the expert committee proposes the following in relation to lending to private borrowers:

1. Inserting a provision in the Danish Financial Business Act and the Housing Credit Institutions Act to the effect that mortgage banks and banks, as well as housing credit institutions, when notifying changes in interest rates, administration margins or fees, are required partly to state the reason for the increase, and partly to explain the most important aspects behind the change.

2. Extending the notice period for increases in interest rates, administration margins or fees from three to four months.

3. Eliminating the rule that interest rate rises may generally be implemented at one month's notice to the effect that the four months' notice period will apply here as well. This adjustment was proposed to ensure equal market terms for loans resembling mortgage loans and mortgage loans.

4. That failure to comply with recommendations 1, 2 and 3 concerning notification and reasons for changes, except for insignificant increases in fees other than interest rates and margins, incurs civil liability. Specifically, this means that announced administration margin increases and rises in interest rate spreads cannot enter into force unless rules are satisfied.

5. A ban against charging prepayment fees, trading commission and price spreads, on prepayment in the notice period in connection with administration margins rises by a mortgage bank or interest rate spread rises for mortgage-like loans by a bank. (Note: The Association of Danish Mortgage Banks, the Danish Bankers Association and the Danish Mortgage Banks' Federation do not find that the Committee's analyses have exposed aspects that could justify such principally extensive steps as a ban against collection of fees in the notice period).

6. On every payment slip of adjustable-rate mortgage loans and mortgage-like loans, information must be provided on the price spread proportion of the interest payable.

7. The notification letter concerning increases in interest rates, margins and fees must include the following information:

   a) The market value of the customer's loan.
   b) That the customer has the option to prepay the loan and take out a new loan in the same mortgage bank or with another loan provider.
   c) That information regarding other loan providers may be found on pricing portals, operated by private providers, and on the pricing portal for housing loans (includes information about current housing loan rates).

8. Terminating the agreement on offering Cita-based mortgage loans if Cibor-based mortgage loans are offered.

New rules to make it easier to understand the loan offer

Borrowers have to read and understand a great deal of information when applying for a mortgage loan. Therefore, mortgage banks have established some common standards for loan documents to make it easier for consumers to understand a loan offer and compare loans.

The new common standards have been prepared jointly by the Association of Danish Mortgage Banks, the Danish Consumer Council and the Danish Bankers Association and are a follow-up on the report about barriers to consumer mobility on the Danish mortgage market.

The borrower will receive a quick guide with instructions for reading the loan offer and where the borrower can find information about the selected loan and its importance to the borrower's financial situation. It will also be highlighted whether the interest rate is fixed or floating and that other loan costs may increase throughout the loan term. Mortgage banks must also use simple and understandable language and as few technical expressions as possible.

Mortgage banks must implement these standards by no later than 1 February 2017. The standards will be evaluated in 2019.

The four standards are:

1. **BRIEF INTRODUCTION TO A LOAN OFFER**
   The borrower will receive a brief introduction to the loan offer and the introduction is to help the borrower understand and navigate the loan documents. The introduction must be a simple tool helping the borrower gain perspective of and navigate the different elements of the loan offer. The borrower must be informed whether the loan rate is fixed or floating and that other loan costs may increase, even if the loan rate is fixed for part of or throughout the loan term.

2. **AS SIMPLE AS POSSIBLE**
   Mortgage banks must use simple and understandable language in the loan documents and as few technical expressions as possible, while also ensuring a correct legal content of such documents. If this is not possible, technical expressions must be explained in a simple and clear manner in the document or in another place clearly visible to the customer.

3. **STRATIFICATION OF INFORMATION**
   In the introduction the parts of the loan documents adapted to the borrower's choice of product must be highlighted. Standard terms may for instance be standard business terms/loan guide.

4. **EASIER COMPARABILITY**
   The introduction must state where in the loan documents the borrower may find the ESIS (European Standardised Information Sheet). This way borrowers which have obtained several offers may use ESIS to compare loan offers.

NEW HOUSING LOAN RULES

The Mortgage Credit Directive has now been implemented, resulting in a new executive order on good practices for housing credit, which entered into force on 9 May 2016. The purpose of the rules is to increase consumer protection when raising housing loans, and all good practice rules in connection with housing loans have now been compiled in a separate executive order. The new rules will apply to all credit providers, including non-financial credit providers. This means that the advisory requirements are the same, regardless of the type of housing credit provider or housing credit intermediary consumers use to obtain a loan.

The rules set out the framework for marketing housing loans, customer advice and the requirements of mortgage banks to provide information before granting a housing loan.

The new rules require lenders and credit intermediaries to
- provide general information about the loan types and products offered;
- provide personalised information to the consumer. This is based on a European Standardised Information Sheet (ESIS). This enables the consumer to compare the loan terms of different lenders;
- provide explanations and meet certain standards for advisory services and assess the consumer's creditworthiness on the basis of consumer information.

Borrowers
- get the information necessary to make the right decisions during all phases of raising a mortgage loan;
- benefit from a harmonised calculation of the annual percentage rate of charge (APRC). The calculation is in accordance with the formula set out in the Consumer Credit Directive. This will make it easier to compare advertisements and information prior to a loan agreement;
- must disclose the information necessary to assess their creditworthiness;
- will be able to compare prepayment options prematurely.

Denmark already has a very high level of consumer protection and is therefore already satisfying many of the new rules. For example, Danish homeowners with mortgage loans were already getting standardised information (ESIS) before the changes and have always been entitled to prepayment which is an inherent part of the Danish mortgage system. Therefore, the new rules are mostly a great improvement for consumers in other countries.

New pricing portal compares housing loan rates from both mortgage lenders and banks

From early 2017, homeowners may avail themselves of a new online tool which compares housing loan rates from both mortgage lenders and banks.

Tools which compare mortgage loan rates are already available today, but this is the first solution providing an integrated comparison of mortgage loans and bank loans. The Association of Danish Mortgage Banks welcomes the new portal and hopes that it will further enhance transparency in the housing market.

BROAD-BASED POLITICAL BACKING FOR NEW HOUSING LOAN PRICING PORTAL

The political agreement on a new housing loan pricing portal was entered into in connection with the 2014 Act Addressing Refinancing Risk (refinancing act). The agreement to create a pricing portal comparing housing loan rates from both mortgage lenders and banks obtained broad political support from the Liberal Party, the Social Democrats, the Social Liberal Party, the Socialist People's Party and the Conservative People's Party.

The new pricing portal was designed by a steering group under the Ministry of Business and Growth with participants from the financial sector and the Danish Consumer Council. The new housing loan pricing portal will be subject to supervision by the Danish FSA.

WHERE TO GAIN AN OVERVIEW

The housing loan pricing portal will be available from the website of the Danish Money and Pension Panel, which already includes much information about housing loans. The portal will show the prices of mortgage housing loans and bank housing loans.

However, portal users will not be able to see the actual average loan rates of borrowers who have taken out a loan, as the average rates (APRC) are calculated on the basis of the highest cost of the listing prices. For loans where not all borrowers are offered the same loan rate, such as housing loans from banks, in addition to the average rate, consumers will be able to see the cheapest rates and the most expensive rates.

For the new housing loans, it will be possible to see the costs of a new loan and the annual percentage rate (APRC) of the loan, calculated on the basis of the principles used in the pricing portal.

STAY UPDATED WITH PRICE TRENDS

In addition to the information provided by the pricing portal on new loans, it will be possible to stay updated with loan rates over time. The pricing portal will continuously compile the rates of new loans to show the price trends of a new loan. At the same time, it will be possible to instantly see the loan rates currently being paid.

Leverage ratio and capital floor requirements challenge Danish mortgage lending

The European Commission is currently working on proposals to introduce a leverage ratio requirement in the EU. At the same time, the Basel Committee is finalising a proposal on permanent floors to credit institutions' capital requirements based on internal models. The proposal differs significantly from the previous risk-based approach of the internal models where low-risk loans are subject to lower capital requirements. The proposed requirements will be tough on Danish mortgage lending, and Danish homeowners and not least small and medium-sized businesses will be facing considerable and entirely unfounded added costs. This will be harmful to growth and employment in Denmark and other EU countries.

CAPITAL REQUIREMENTS SHOULD BE RISK-BASED

Risk-based capital requirements mean that low-risk loans are subject to lower capital requirements. To put it simple, the higher the risk, the more capital must be held to cover potential losses. It makes good sense that a credit institution offering low-risk loans should not hold the same amount of capital as an institution offering high-risk loans. This ensures a sound incentive structure in the credit institutions. However, the proposed leverage ratio and capital floor requirements break with the risk-based approach to capital requirements.

This break with the risk-based approach is irrational, as secure loans become more expensive, and it may motivate financial institutions to lean towards more risky exposures. This is completely out of step with the common desire to create a safer and more stable financial sector.

Not least Danish mortgage banks will be hit hard by these proposals. Danish mortgage loans are highly secure and the risk of loss is very low. Under the current rules, in determining the level of capital to be held as collateral for loans, the mortgage banks may to some extent "factor in" this high level of security in their internal models.

However, if the new requirements are introduced, loans from Danish mortgage banks will rank pari passu with high-risk loans from countries that do not have equally advanced mortgage models as the Danish one. This is because credit institutions with the lowest risk on loans will get no credit for this if the capital requirement is completely detached from the institution's risk profile (as a leverage ratio) or if low risk levels are not recognised (as with capital floors to internal models). See the boxes on page 15 for a definition of the two requirements.

A leverage ratio or capital floors which are made binding for low-risk lending will have full impact on specialised banks and low-risk business models, such as Danish mortgage banks, because we only have secure loans on the books. Calculations from the Association of Danish Mortgage Banks, the Danish Bankers Association and the Danish Mortgage Banks' Federation show that Danish banks and mortgage banks must raise around DKK 130bn of additional capital if the Basel capital floors are introduced as drafted in spring 2016. This would be extremely costly and impose completely unreasonable and unfounded costs on Danish homeowners. The Basel requirements do not just affect homeowners – also businesses and agriculture will suffer a severe blow, to the detriment of growth and employment.

UNNECESSARY REQUIREMENTS

The Basel Committee works with international banking rules and has drawn up the proposals to introduce a leverage ratio and the new and tougher capital floors.

The Basel Committee has suggested introducing a minimum leverage ratio requirement of 3% of the total portfolio and possibly a surcharge for global systemically important financial institutions (G-SIFIs). The leverage ratio requirement is intended to act as a backstop to the risk-based capital requirements. According to the Basel Committee, a leverage ratio requirement may provide an extra layer of protection from the uncertainty associated with the internal models used by banks to calculate their capital requirements.

The Association of Danish Mortgage Banks does not favour introducing non-risk-based capital requirements. The current rules and requirements for internal risk models already take into consideration uncertainty factors and possible measurement errors. In addition, banks' use of internal models is subject to considerable control and supervision. The models must be approved by the Danish FSA, and the models and their results are continuously assessed. If the internal models are challenged, instead of introducing rules that only affect low-risk loans, it would be better to consider improving the models and strengthening the supervision of these models.

In Danish as well as European contexts, a leverage ratio requirement is being discussed on the basis of the Basel Committee's proposal. By end-2016, the European Commission must present a report to the Council of Ministers and the European Parliament assessing the consequences and impact of a leverage ratio requirement. If required, the European Commission may have its report be accompanied by a legislative proposal. Any such proposal is expected to be incorporated into the CRRII/CRDV package.

Based on the political agreement on Bank Rescue Package 6, Denmark set up an expert group on leverage ratio requirements for credit institutions. The purpose of the group was to form a Danish opinion prior to EU discussions on a harmonised leverage ratio requirement. The expert group published its recommendations in December 2015. Among other things, the expert group recommended that risk-based capital requirements should continue to form the backbone of capital requirement regulation, that the drafting of the leverage ratio requirement should take into consideration specialised banks with a particularly secure business model, such as Danish mortgage banks, and that the government accepts a harmonised 3% leverage ratio requirement at EU level.

The Basel Committee is expected to end its reflections concerning capital floors by end-2016. Any EU implementation process is awaiting the final Basel Committee recommendations.

The Association of Danish Mortgage Banks has been continuously working to put focus on the proposals' adverse effect on the Danish mortgage system and the Danish economy in general. Among other things, we have presented our arguments to the Basel Committee, the European Commission and the Danish authorities. The Chairman of the Association of Danish Mortgage Banks, Michael Rasmussen, met with the Chairman of the Basel Committee, Stefan Ingves, in May to convey our concerns about the coming regulation. The Danish Minister for Business and Growth has also addressed the Danish challenges with the proposals directly to the Basel Committee. In June 2016, the Association of Danish Mortgage Banks, the Danish Bankers' Association and the Danish Mortgage Banks' Federation briefed politicians and government officials in Brussels about the Danish calculations and the socio-economic consequences of the proposals.

The Association of Danish Mortgage Banks will continue to promote that financial sector regulation is based on the risk-based approach.

NEW MARKET RISK REQUIREMENTS IN THE PIPELINE

In January 2016, the Basel Committee published its revised market risk framework. These rules should not be confused with the Basel Committee's ongoing work on the so-called capital floors described above.

As all other markets, the market for covered bonds is also dependent on "brokers" (covered bond brokers), purchasing for/selling from stock. The revised market risk framework specifies the level of capital to be held by banks for holding a stock of covered bonds in their capacity as brokers. It also specifies the price of holding a stock for trading purposes.

The requirements do not at all reflect the real risk of holding a stock of covered bonds. If implemented into EU legislation, the revised market risk framework will cause an increase in bond brokers' costs of holding a stock of covered bonds.

If Danish mortgage banks cannot sell or buy back their covered bonds because there is no efficient market for them, the Danish mortgage model will be hit hard. Ultimately, it will hit borrowers in the form of higher loan rates and will be harmful for growth and employment in Denmark.

The above should also be viewed in light of a number of other new rules, such as the leverage ratio, which may damage the effectiveness of the bond market. And unfortunately, there are some signs in the market suggesting that parts of the new regulation have a negative effect on market liquidity.

What is a leverage ratio requirement?

With a leverage ratio requirement a credit institution is required to meet a specific leverage ratio, which is a non-risk-based measure of the ratio between the capital and total assets of a credit institution (a substantial part of which is lending). The capital requirements already implemented are risk-based. A non-risk-based leverage ratio does not take into consideration the level of security of the credit institution's assets. A leverage ratio requirement thus sets a limit for the extent of lending by a credit institution in relation to its capital. The higher the required ratio, the lower the amount of lending allowed relative to the capital of the credit institution.

What is a capital floor requirement?

A capital floor sets a lower limit to a credit institution's capital requirement. The floor may be introduced directly on the overall capital requirement (capital floor) or on different elements of the capital requirement determination (parameter floors). For example, if a capital floor is introduced on a risk-based model for calculating the capital requirement of a credit institution, the risk/capital requirement relationship is decoupled for the assets (for example loans) of a credit institution less risky than the floor value. Thus, the credit institution is not rewarded for holding loans involving lower risk than the floor value.

Yet another liquidity requirement will harm the Danish mortgage system

The European Commission is expected to propose a "stable funding" requirement, and this may be detrimental to the Danish mortgage model. The requirement may render covered bonds a less attractive source of funding than less secure bonds and deposits. Danish mortgage banks are particularly hard hit due to a special Danish scheme which takes account of the bondholders. Overall, this may result in significantly more expensive housing and business loans.

NSFR - THE 1-YEAR LIQUIDITY RULE

The Basel Committee, which works with international regulation, introduced a so-called Net Stable Funding Ratio (NSFR) as part of Basel III. The NSFR is to ensure an appropriate balance between the maturity profiles of credit institutions' lending and funding. Danish mortgage loans are characterised by a perfect match between loans and bonds, which makes for stable funding. However, our stable funding model is not fully recognised. The Basel Committee's final recommendations should therefore be amended in a number of respects if the NSFR is to be implemented in the EU.

DANISH MORTGAGE BANKING PENALISED FOR ITS HIGH SECURITY

Generally, the recommendations place home loans funded by bonds of the SDO and RO types (Danish covered bonds) in a less advantageous position than home loans funded by other means, for example by deposits. This is because of a rule which is to prevent inappropriate behaviour in universal banks, but which has a highly adverse effect, for example on Danish mortgage banks. At the same time, seen from a stable funding perspective, the recommendations actually encourage banks to fund their lending with sources that are less stable than Danish covered bonds.

As opposed to foreign mortgage models, holders of Danish covered bonds have a preferential right to all assets of a Danish mortgage bank. This increases bondholders' security compared to other mortgage models. The extra security feature may become too expensive for the mortgage banks, however. This is because the Basel Committee's NSFR rules require that, in addition to the lending to which investors have preferential rights, liquidity and other assets must also be funded with very stable funding – in the view of the Association of Danish Mortgage Banks this rule is based on erroneous grounds. This requirement does not apply to universal banks where bondholders do not have preferential rights to all the bank's assets.

THE DANISH REFINANCING ACT MUST BE FULLY RECOGNISED

The Danish 2014 refinancing act recognised short-dated bonds with a maturity extension feature as stable funding. It is therefore a problem that the NSFR rules do not clearly recognise the Danish refinancing act. Thus, it is imperative that short-dated bonds with a maturity extension feature are recognised as stable funding if the NSFR is implemented in the EU. If not, this will be very damaging for mortgage banks' offering of adjustable-rate mortgage loans and other variable-rate loans funded by short-dated bonds.

ALL COVERED BONDS SHOULD BE RECOGNISED AS VERY SECURE AND LIQUID

If the Basel Committee's recommendations for NSFR rules are implemented in their present form, it will also become more expensive for investors to hold Danish covered bonds. The reason is that the Basel Committee does not recognise the very high security and liquidity of covered bonds, and the criteria for them to qualify as stable funding are therefore far stricter than those applying to, for instance, government bonds.

In the view of the Association of Danish Mortgage Banks, if the NSFR is implemented in the EU, the qualities of Danish covered bonds should be fully recognised, and the criteria for them to qualify as stable funding should be the same as for government bonds. On top of that, Danish covered bonds should not be treated differently according to the size of series, as was the result when the short-term Liquidity Coverage Ratio (LCR) was implemented in the EU. As opposed to some other asset classes, there is no difference in quality between large and small series of Danish covered bonds. Otherwise, the demand for these bonds will decrease, resulting in higher loan costs. That is completely unacceptable considering the very high credit quality and liquidity of Danish covered bonds.

PROPOSAL FOR NSFR RULES FOR EU IMPLEMENTATION EXPECTED BY END-2016

At end-2016 the European Commission may opt to submit a proposal to the Council of Ministers and the European Parliament for the introduction of the NSFR in the EU. This option is set out in the Capital Requirements Regulation (CRR). A proposal to this effect is expected to be incorporated into the CRRII/CRDV.

The Association of Danish Mortgage Banks supports the efforts to ensure a better match between institutions' lending and the funding thereof. In light of the existing errors and omissions in the final NSFR recommendations by the Basel Committee, it is also positive that any implementation at EU level will be fine-tuned by the European Commission, the Council of Ministers and the European Parliament.

In this connection, we are pleased that the difficulties of accommodating specialised banking models, such as the Danish mortgage model, in the Basel Committee's recommendations for NSFR rules, are highlighted in a report on the NSFR prepared by the European Banking Authority (EBA). The report to apply as basis for any proposals by the European Commission for NSFR rules also recognises the high degree of security in the Danish mortgage model.

About the NSFR and funding mismatch

During the financial crisis, some banks and mortgage lenders experienced that it was suddenly difficult to raise capital to fund new and existing loans to their customers. The reason was that large parts of the financial sector had issued long-term loans to their customers, but had funded these loans with deposits and/or short-term funding from other banks. This funding mismatch created a need for ongoing refinancing. As uncertainty spread across the financial markets, it became difficult or impossible to find investors who were willing to refinance the short-term funding used by the banks to fund their lending.

The purpose of the stable funding rule is to ensure an appropriate match between the maturity of institutions' lending and deposits. More specifically, loans with a term-to-maturity over 1 year must be matched by stable funding. This means, for example, that a mortgage bank with a large proportion of long-term lending that is funded by short-term loans from depositors and other banks will not comply with the NSFR requirement.

The proposed NSFR has been introduced as a soft requirement for an observation period running until 2018 inclusive. Based on test reporting, the EBA submitted a report to the European Commission on the NSFR in December 2015. The report contained a recommendation to introduce the NSFR as a hard requirement. If the European Commission finds it appropriate, it will make a proposal to introduce the NSFR requirement by end-2016. Such proposal will then undergo a political process in the Council of Ministers and the European Parliament. A proposal to this effect is expected to be incorporated into the CRRII/CRDV.

The NSFR is expected to be phased in from 2018 at the earliest.

Covered bond legislation in the EU

The European Commission is considering new covered bonds regulation. The purpose is to increase international investors' interest so that EU capital markets may attract more investments from countries outside the EU, thus supporting and promoting growth and employment in the EU. Denmark is hoping that the European Commission's considerations will pave the way for higher recognition of the Danish mortgage model.

In autumn of 2015, the European Commission launched a detailed consultation about regulation of covered bonds. This was part of the European Commission's action plan for a capital market union, the Capital Markets Union Action Plan, which was published on 30 September 2015. In December 2015, the Danish Bankers' Association, the Danish Mortgage Banks' Federation, and the Association of Danish Mortgage Banks presented their joint consultation response with recommendations for the European Commission on the framework of European legislation.

One of the key messages to the Commission is that it is crucial that the regulation of covered bonds at European level be based on the fundamental principles behind viable mortgage models such as the Danish model, as this may raise international investors' understanding of the European covered bonds tradition.

Moreover, Denmark is hoping that recognition of specialised mortgage models might reduce the number of battles regularly being fought by Danish authorities, politicians, government officials and organisations at EU level to ensure the survival of Danish mortgage lending.

The Danish mortgage model has many strong elements which should be used as inspiration at EU level. The Danish mortgage model is perhaps the most transparent in the EU. The match funding principle offers market-based prices and minimises all risk other than the credit loss risk. Our unique prepayment system ensures that borrowers can prepay their loans by buying the underlying bonds of the loan at market rates. Borrowers may take advantage of this option when market rates are in their favour. Furthermore, the Danish mortgage model is subject to a number of strict requirements and supervision from the financial supervisory authorities and the model is also characterised by a very high level of consumer protection. The Danish mortgage system is stable and robust, and it has proved efficient during both upturns and downturns in the Danish economy. This makes it attractive for investors and makes it one of the world's most attractive and least expensive models for housing and property financing in the EU improving the competitiveness of businesses and consumers' finances.

In its consultation response, the Association of Danish Mortgage Banks stresses that it is vital that covered bonds continue to be extremely secure and offer stable funding of very high quality compared with other – and riskier – types of funding. The Association of Danish Mortgage Banks has emphasised the following aspects to the European Commission:

1. Considering the importance of the Danish covered bond market, omission of the Danish market from the European Commission's analysis may lead to the wrong conclusions.

   The Danish covered bond market is the world's largest measured as % of GDP. At end-2015, outstanding Danish mortgage lending amounted to about EUR 370bn corresponding to about 140% of GDP.

2. To ensure financial stability and create a solid foundation for economic growth, all legislative initiatives concerning covered bonds must recognise the universal banking model and the specialised banking model such as the Danish model which solely issues bonds secured on real estate.

3. In order to strengthen foreign investors' confidence in covered bonds, the security of the assets, for example real estate, must be subject to strict requirements.

4. Covered bonds extensively provide funding to small and medium-sized businesses. However, it is important to understand that the funding is based on the security in the properties of these businesses and not on whether they are defined as small and medium-sized businesses. Covered bonds ensure that small and medium-sized businesses have access to affordable funding.

The European Commission has not yet decided the further process for any regulation of covered bonds. The options mentioned by the European Commission range from recommendations on good practice for covered bonds to actual legislation in the form of either a directive or a regulation – or a combination thereof. The Association of Danish Mortgage Banks finds it essential that content is prioritised over form.

The European Commission is expected to conduct an external study of the area in the autumn of 2016. Once this study is available – probably during 2017 – the European Commission is expected to have the basis for assessing the way forward.

The Association of Danish Mortgage Banks is hoping that working at European level may result in an increased understanding and recognition of the fact that specialised mortgage models, such as the Danish model, increase financial stability and improve financing terms and opportunities for businesses, including small and medium-sized businesses, agriculture and consumers.

The role of European financial supervisory authorities

The extensive EU regulation of the financial sector has become increasingly relevant for politicians. This extends to the European Commission which calls for less but better regulation. Furthermore, the sector has been consulted about the rules already adopted – whether they work as intended or if there is room for improvement.

Greater focus in Denmark and in the EU on the risk of over-regulation and on any negative side-effects of the many initiatives implemented since the financial crisis is positive. It is important to create better conditions for growth and employment in Europe. Therefore, it is crucial not to introduce unnecessary limitations on the providers of loans to businesses and consumers.

The rules adopted by the European Parliament and the Council on the basis of proposals from the European Commission are only the tip of the iceberg. The rules for the financial sector are largely set by government officials, either as delegated instruments or as guidelines, with a very minor degree of political control and influence in common.

The three European financial supervisory authorities play an important role in terms of financial sector regulation. They work in the banking area (EBA), the securities trading area (ESMA) and in the insurance and labour market area (EIOPA).

In addition to supervision, the supervisory authorities are tasked with drafting binding rules for the European Commission to adopt, and with preparing guidelines as required.

These are quite extensive powers, as the Council of Ministers and the European Parliament often leave it to the Commission and thus the supervisory authorities to complete politically adopted rules.

Even though the rules by government officials often appear as mere technicalities, this is far from the case. There may be political choices to make at this level as well. And even though guidelines seem informal, national supervisory authorities are obliged to follow them according to a ”follow or explain” principle.

The Association of Danish Mortgage Banks supports an efficient supervisory regime in the EU to oversee compliance with the rules of the single market. However, supervision must be based on facts and thorough analyses and a clear mandate from legislators. The supervisory authorities should not politicise. The framework for European supervisory authorities' activities should be firmer, and supervisory activities should be subject to better democratic influence and control.

One place to start is the European Commission's initiative on ”Better Regulation” from 2015. The initiative is to ensure increased use of impact assessments before suggesting new legislation, and evaluating whether the existing legislation is working as intended. It is also to ensure that relevant stakeholders are involved in the legislative process. It is a welcome contribution, as it brings attention to the quality of the legislation adopted by the EU.

It is crucial, however, that this focus does not merely remain at the tip of the iceberg – ie the rules adopted by the Council and the European Parliament. Also the elaborate rules and guidelines from the European Commission and the European financial supervisory authorities should be assessed according to the same principles.

Revision of the mortgage registration fee

The Danish government has set up a working group which is to overhaul for instance the mortgage registration fee. The Association of Danish Mortgage Banks welcomes this initiative. The current mortgage registration fee act was drawn up when mortgage registration was carried out on paper. The full potential of the digital mortgage registration system, which was introduced in 2009, is therefore unexploited.

The government has focused on making it easier and more affordable to run a business in Denmark, and a cross-ministerial taskforce has therefore been appointed to clean up the mess of excise duties. The taskforce is analysing national consumer and environmental duties to assess whether a restructuring of these duties may simplify running a business in Denmark.

Also a restructuring committee has been set up to work as reference group to the cross-ministerial taskforce. The committee comprises members recommended by trade organisations and sectoral organisations. The Association of Danish Mortgage Banks is represented in the restructuring committee.

In the opinion of the Association of Danish Mortgage Banks, fee rules should be easy to understand for the users and not be disproportionately resource-consuming for professional participants in the area. Fees which result in disproportionate administrative burdens should be altered to make them easier to administer. Furthermore, products should typically be treated the same.

The mortgage registration fee is part of the terms of reference for the analysis. The existing rules are complex, and it is difficult to understand and calculate the fee payable on mortgage registration. In connection with mortgage registration, professional participants make a number of manual manoeuvres to ensure that customers pay the lowest mortgage registration fee possible. This is resource-consuming and administratively burdensome for professional participants whereas customers experience the process as obscure and difficult to understand.

The current mortgage registration fee act was passed when mortgage registration was carried out on paper. The full potential of the digital mortgage registration system, which was introduced in 2009, is therefore unexploited.

THE ASSOCIATION OF DANISH MORTGAGE BANKS' PROPOSAL ON REVISING THE MORTGAGE REGISTRATION FEE

The Association of Danish Mortgage Banks has proposed two different solutions to the restructuring committee before the summer break. In both models, the rules are streamlined to ease the administrative burdens for professional participants and the public sector, and to create greater legal protection for consumers. The models were prepared in collaboration with the Danish Mortgage Banks' Federation and the Danish Bankers Association.

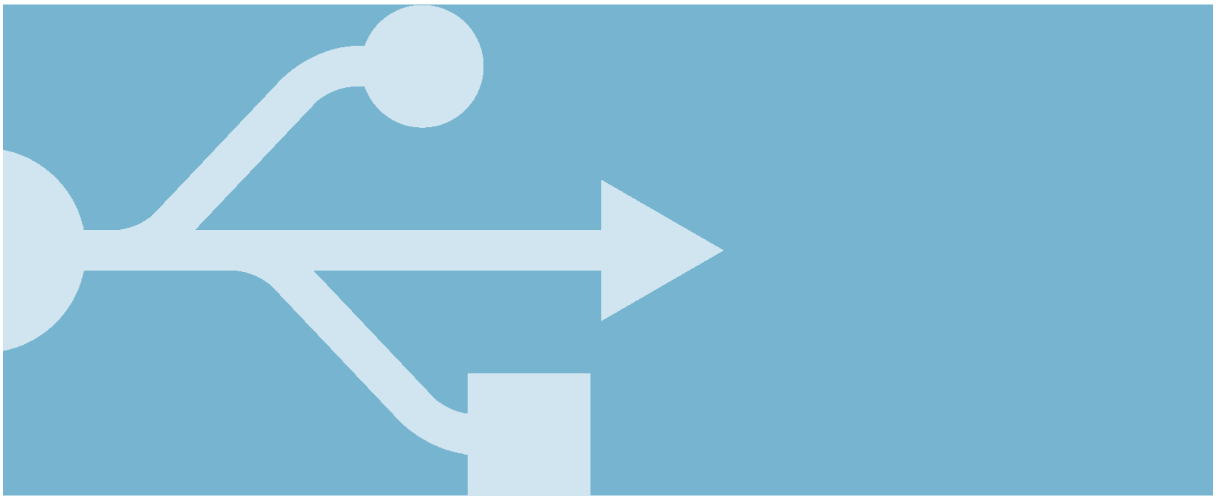
Both models include simplification of the fee rules on registration of mortgages over real estate and housing cooperative units. It is proposed to extend the options for transferring fees from one mortgage to another to adapt the rules to the scope of the digital mortgage registration system.

Model 1 entails paying a variable fee for a new mortgage or an extension an existing mortgage, as well as paying a fixed fee on the registration of mortgages. This means that more mortgage registrations are subject to a fixed fee than under the current rules, while the variable fee can then be reduced slightly.

Model 2 entails paying a variable fee for a new mortgage or for an extension of an existing mortgage, and that no fixed fee is payable on mortgage registration.

The abolishment of the fixed mortgage registration fee leads to an increase in the variable fee. However, this model makes it less expensive to switch mortgage banks and refinance loans, as the fixed fee is no longer payable. With this model, the variable fee will be higher than today, but it will also be relatively more expensive to take out new loans.

The restructuring committee will also be proposing revisions of the mortgage registration fee act in the autumn. The overall restructuring analysis must be completed in spring 2017 so that parts of it may be implemented as part of the 2018 Finance Act.



New legislation in the pipeline: Mortgaging digital infrastructure

In February 2015, a political agreement on a digitisation growth plan was concluded, which is to advance mobile and broadband coverage and digitisation of Danish businesses. It was decided to amend legislation to include the option of financing digital infrastructure with loans from mortgage banks.

Financing digital infrastructure by way of mortgage loans rather than for example taking out a secured bank loan or issuing corporate bonds is expected to reduce the costs of expanding digital infrastructure.

The Association of Danish Mortgage Banks has since worked with the authorities to find a legally and practicably viable solution.

The bill will include a new section 37a in the mortgage registration act where a cluster of properties can be mortgaged under a blanket mortgage. Such a mortgage will also include the machinery connecting the properties owned by the enterprise, and the cables running through rented properties.

The bill will be submitted in autumn 2016, and we look forward to seeing the final text of the bill so that affordable mortgage lending may help boost digitisation.

The bill is not expected to take effect until 1 January 2017.

Lending activity

In 2015, lending activity in the Danish mortgage market was characterised by a refinancing surge at the beginning of the year. Even though the refinancing surge tapered off in H2/2015 along with increasing interest rates, overall, we have not seen higher refinancing activity since 2005.

Despite the considerable refinancing activity, loan growth continued at a more subdued rate. At end-Q2/2016, total bond debt outstanding was DKK 2,610bn, which is 1.7% more than two years ago. Of the total loan stock, interest-only loans are less dominant and fixed-rate loans more dominant than previously.

HOMEOWNERS

Total homeowner loans came to DKK 1,499bn at end-Q2/2016. Lending to homeowners has increased by 1.9% in the past year.

Many homeowners exploited the culmination of several years' interest rate declines in connection with the upward pressure on the DKK in January and February 2015 and refinanced their loans. Particularly the opportunity to take out a fixed-rate loan with a 2% coupon was exploited. In 2015 and H1/2016, 65.0% of new loans for homeowners were fixed-rate loans. This means that fixed-rate loans for homeowners have become increasingly popular at the expense of loans with short-term interest periods. At end-Q2/2016, 38.0% of total lending to homeowners was fixed-rate, cf Chart 1. That is 1.4pp more than one year ago.

Conversely, floating-rate loans are less dominant than before. Particularly loans with the shortest interest periods are less dominant. At end-Q2/2016, loans with up to one year to the next interest fixing made up 14.2% of the total loans for homeowners. This is a decline of 6.1pp compared with last year.

The first interest-only loans were paid out in 2003. Many of the loans have an interest-only (IO) period of 10 years, which means that over the past few years many homeowners have seen the expiry of their IO period. No significant problems have been ascertained for borrowers in connection with the expiry of IO periods. Interest-only loans for homeowners have been falling since 2013. At end Q2/2016, 51.4% of total homeowners loans were interest-only loans, cf Chart 2. This means that the share of IO loans has fallen by 5.2pp since 2013. For the past year, homeowners have made DKK 28.7bn worth of principal payments, which is DKK 2.7bn more than in the previous year.

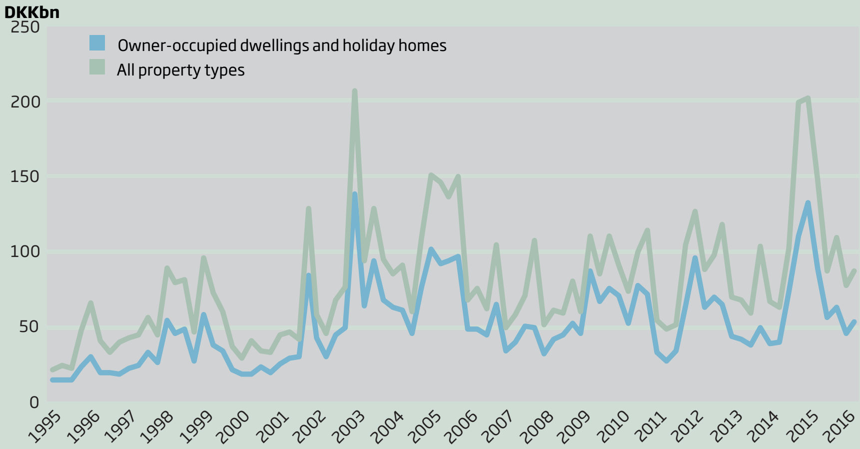
BUSINESS AND OTHER LENDING

Mortgage banks' lending to agriculture, industry/trades, office/retail, public housing, private rental properties and other properties totalled DKK 1,111bn at end-Q2/2016. Lending has increased by 1.5% in the past year. Private rental properties, agriculture and office/retail represented the largest segments with lending of DKK 287bn, DKK 278bn and DKK 275bn, respectively.

In terms of lending to agriculture, the Danish Agriculture & Food Council, the Danish Bankers Association, the Association of Danish Mortgage Banks last year agreed with the former government to put focus on agricultural initiatives. Focus is on the debt and earnings crisis in agriculture and the aim to create stronger financial frameworks for Danish agriculture. As part of the agreement, an investment fund, Dansk Landbrugskapital (DLK) is to be set up. During autumn, the growth fund will present a model for Dansk Landbrugskapital.

Chart 1:

Principal payments and pre-payments on mortgage loans by property type

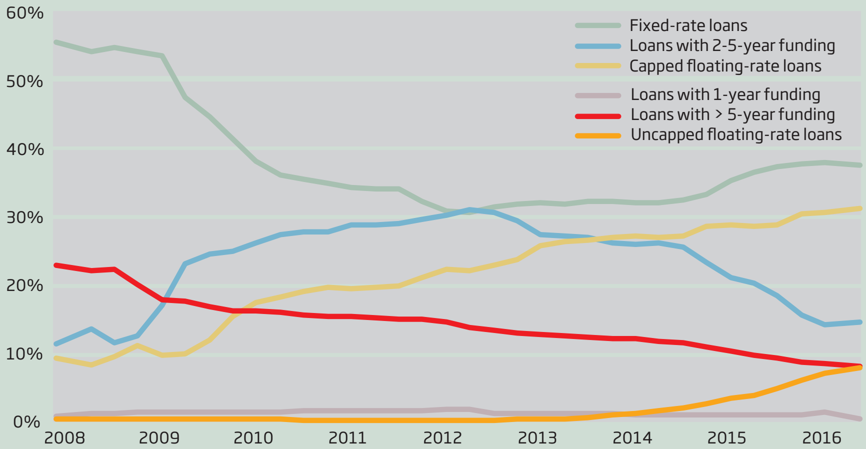


Source: Association of Danish Mortgage Banks

Chart 2:

Loans outstanding for owner-occupied dwellings and holiday homes by loan type

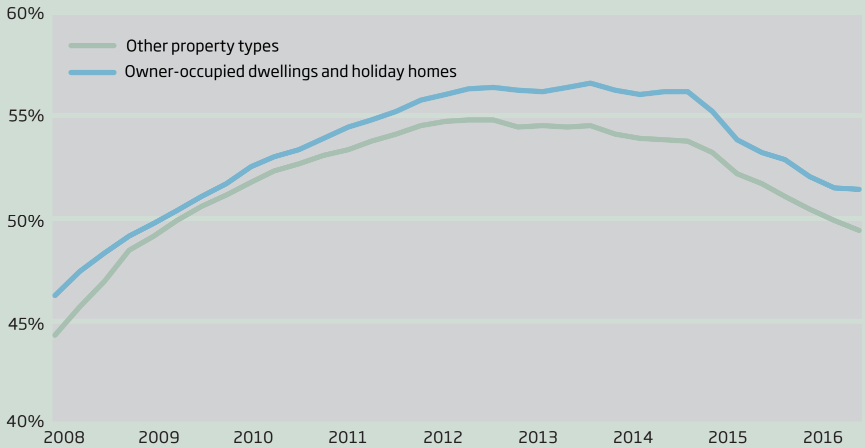
Note: Loan type determined on the basis of time to next loan rate adjustment and not as the initial loan type.



Source: Association of Danish Mortgage Banks

Chart 3:

Interest-only loans, 2008-2016



Source: Association of Danish Mortgage Banks

Housing market trends

House and flat prices soared at the beginning of 2015, and subsequently flattened in H2 and then rose again in spring 2016. The price increases in 2016 were at a more moderate pace than in the beginning of 2015. Sales activity in the housing market also picked up in 2015.

In Q2/2016 the price of detached and terraced houses in Denmark were 3.4% higher than one year ago whereas the price of flats have increased by 8.1%, cf Charts 4 and 5. Both housing and flat prices have increased in all regions in the past year.

The number of transactions in 2015 increased by about 21% compared with 2014. More houses and flats were sold in 2015 than in the past ten years. The increase in sales activity has been underway in all regions in the past years, but particularly the very high activity level in the Capital Region supports the very high number of transactions in Denmark in 2015. The number of houses and flats sold in H1/2015 was not matched in H1/2016. Still, sales activity was high in H1/2016 when compared with the past ten years.

HOUSING SUPPLY

In June 2016, 39,380 houses, 7,385 owner-occupied flats and 13,321 holiday homes were listed for sale with Danish real estate agents, cf Chart 6.

In the past year, an additional 46 houses, 586 owner-occupied flat and 542 holiday homes were listed for sale. The number of permanent dwellings for sale peaked in the summer of 2011 with a total of about 59,000 units. Since then, the overall number of houses and flats for sale has fallen by about 12,000 homes. Despite falling supply in the past five years, more houses are for sale today than on average in the past ten years – the opposite applies to flats.

TIMES-ON-MARKET

In Q2/2016 it took seven months on average to sell a detached or terraced house, see Chart 7. The time-on-market for houses has declined by eight days in the past year. It took an average of four and 10 months, respectively, to sell a flat or a holiday home. The time-on-market for flats and holiday homes has decreased by 8 and 17 days compared with Q1/2015.

ARREARS

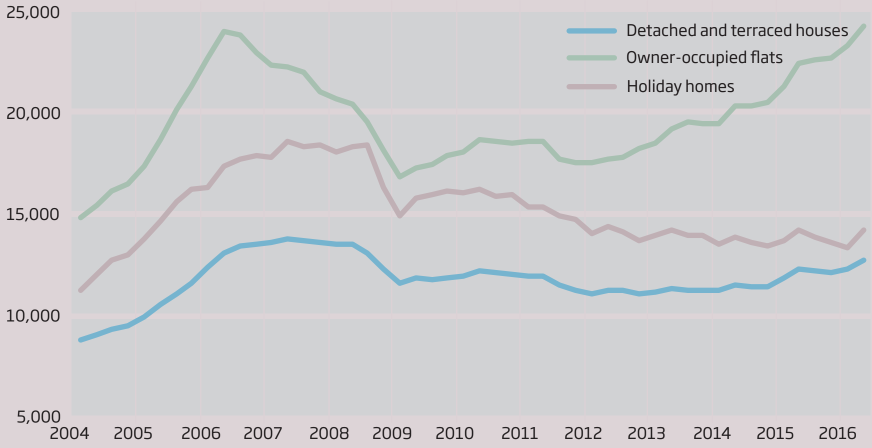
In Q2/2016 the arrears ratio was 0.19%, meaning that for each DKK 100 of mortgage payments due, DKK 0.19 was in arrears. The arrears ratio has declined by 0.08pp compared with Q2/2015. During the economic downturn in the early 1990s, the arrears ratio was around 2.5%, cf Chart 8. Today's low arrears ratio should be viewed against a relatively low unemployment rate and the very low interest rate level. This means that most homeowners can afford their mortgage payments and thereby avoid falling into arrears.

FORCED SALES

3,537 forced sales were announced in 2015. This is almost on a par with the number in 2014 but lower than in 2009-2013. The number of forced sales declined further in early 2016. In H1 we saw 1,500 forced sales, and this is comparable with about 1,700 in the corresponding period of 2015. The number of forced sales generally varies from one month to the next, but 2016 has seen an average of 240 per month. During the crisis in the 1990s, the monthly average was some 1,500 forced sales, cf Chart 9.

Chart 4:

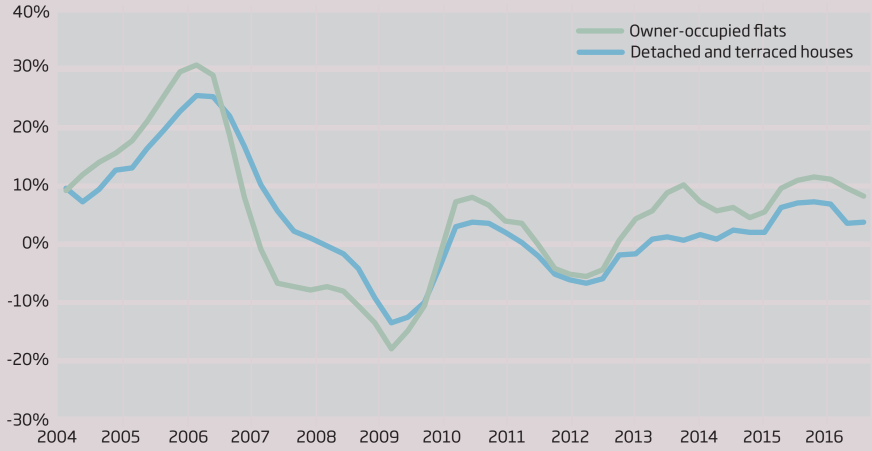
Prices of owner-occupied dwellings across Denmark, 2004-2016, DKK/sqm



Source: Housing Market Statistics

Chart 5:

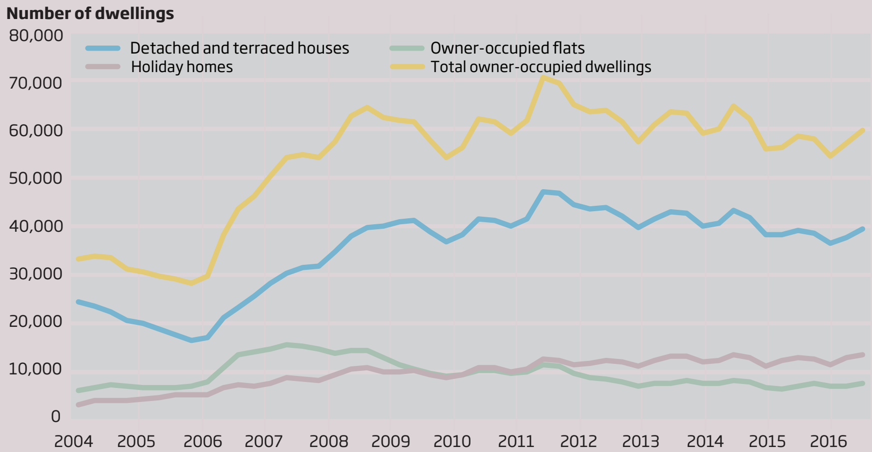
Prices of owner-occupied dwellings across Denmark (annual increase), 2004-2016



Source: Housing Market Statistics

Chart 6:

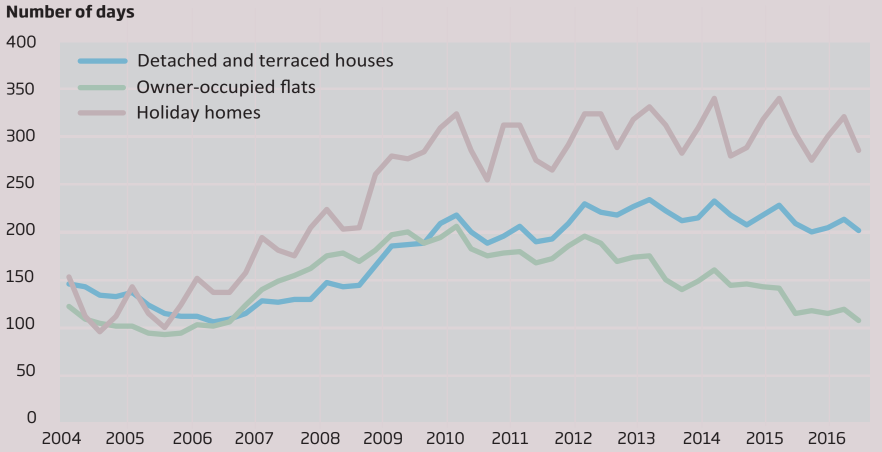
Owner-occupied dwellings listed for sale, entire country, 2004-2016.



Source: Association of Danish Mortgage Banks

Chart 7:

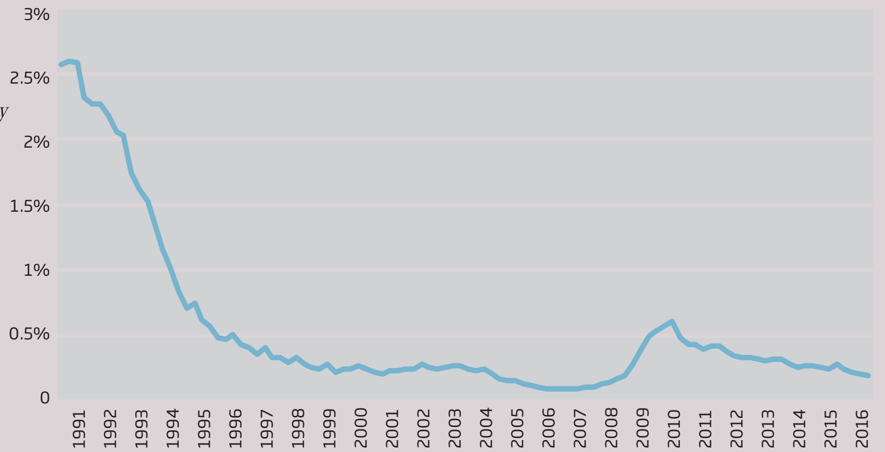
Times-on-market, entire country, 2004-2016



Source: Association of Danish Mortgage Banks

Chart 8:

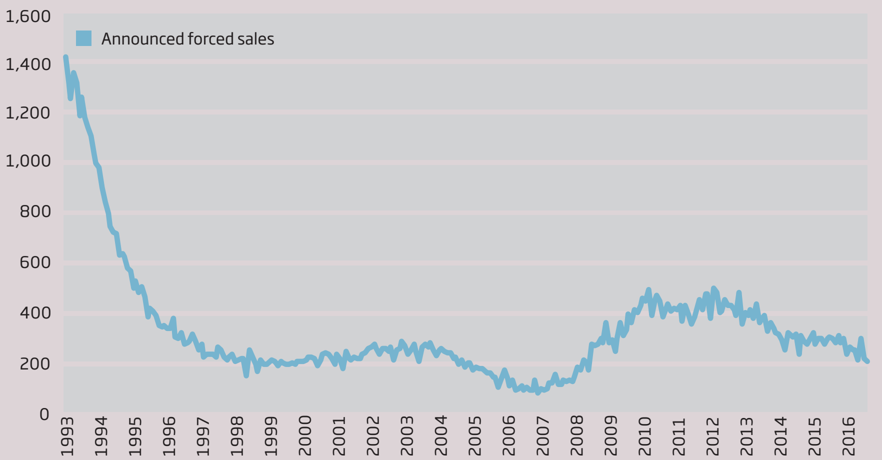
Arrears ratio for outstanding mortgage loans for owner-occupied dwellings and holiday homes, 1991-2016



Source: Association of Danish Mortgage Banks

Chart 9:

Total forced sales (adjusted for seasonality), 1993-2016



Source: Statistics Denmark

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The Association of Danish Mortgage Banks (4)

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The Association of Danish Mortgage Banks (1)

The Association of Danish Mortgage Banks has a secretariat of around 27 employees. The secretariat is organised into specialised departments and has an EU-based representative office in Brussels. Head of the secretariat is Ane Arnth Jensen, Director General.

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