

A more integrated Covered Bond Framework? Assessing the Options

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Structure of the Danish financial system

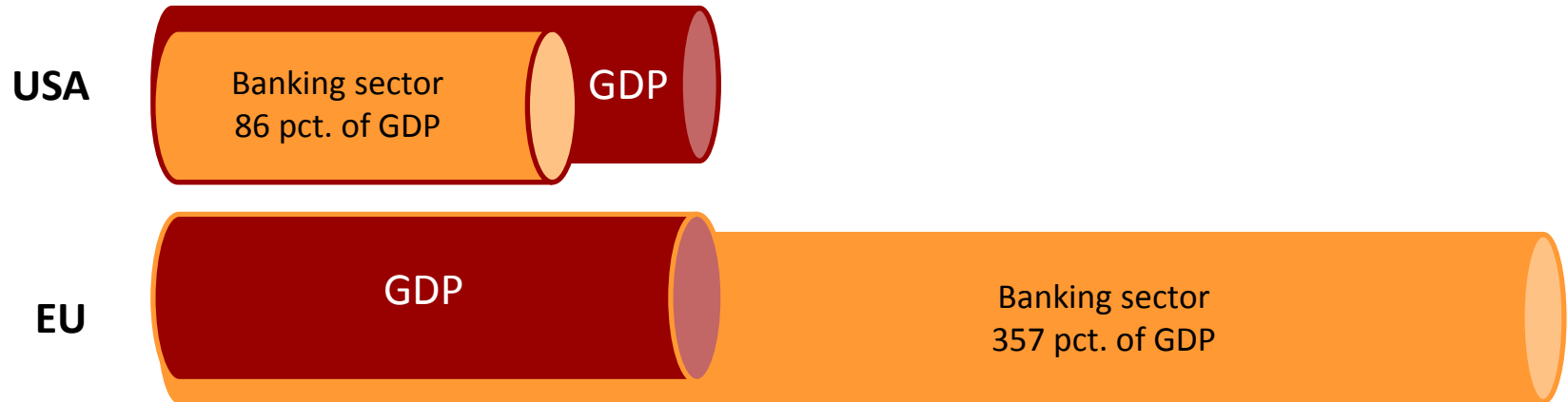
	Banks and mortgage institutions		Non-financial corporations	
	Assets	Liabilities	Assets	Liabilities
Deposits	37%	173%	13%	0%
Bonds	68%	178%	7%	10%
Loans	301%	31%	44%	104%
Shares and other equity	15%	22%	125%	233%
Other	26%	28%	26%	21%
	General government		Households	
	Assets	Liabilities	Assets	Liabilities
Deposits	12%	1%	50%	0%
Bonds	8%	46%	4%	0%
Loans	14%	13%	0%	127%
Shares and other equity	22%	0%	65%	0%
Other	7%	7%	152%	11%
	Pensions and insurance		Danish Central Bank	
	Assets	Liabilities	Assets	Liabilities
Deposits	5%	0%	9%	27%
Bonds	70%	0%	15%	17%
Loans	2%	7%	1%	6%
Shares and other equity	83%	11%	0%	4%
Other	14%	157%	2%	1%
	Mutual funds		Rest of the world	
	Assets	Liabilities	Assets	Liabilities
Deposits	6%	0%	60%	33%
Bonds	62%	0%	80%	76%
Loans	7%	16%	24%	52%
Shares and other equity	166%	178%	80%	115%
Other	11%	9%	20%	24%

 = Bonds

 = Deposits and loans

Relative size of the banking sectors in the EU and the USA

- The banking sector in the EU and Denmark is much larger than in the USA
- This reflects an underlying difference in the financial structures



Differences in the financial structure

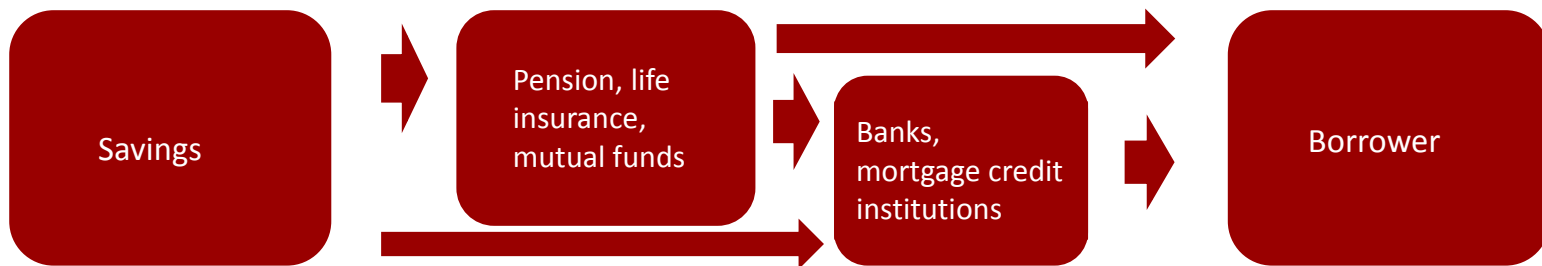
The US model



The Continental model



The Danish model



Core elements of Danish mortgage credit

- Danish mortgage credit has certain core elements crucial in the context of future integrated covered bonds framework
 - Specialized institutions funding loans solely through the issuance of bonds and no access to e.g. deposits
 - Match funding where there is a close match between a loan and the corresponding bonds funding the loan
 - The balancing principle effectively limiting both liquidity, funding and market risk
 - A capital centre structure with separate capital/OC requirements to each centre and to the mortgage credit institution in general
 - A capital centre structure without requirements specifying that each capital centre should be a separate legal entity
 - Specialized insolvency rules enabling a non-forced and gradual winding down of the mortgage credit institution

Universal bank vs. mortgage credit institution

Balance sheet of a (simple) bank

Assets	Liabilities
Loans	Liquid deposits
Liquid assets	Capital

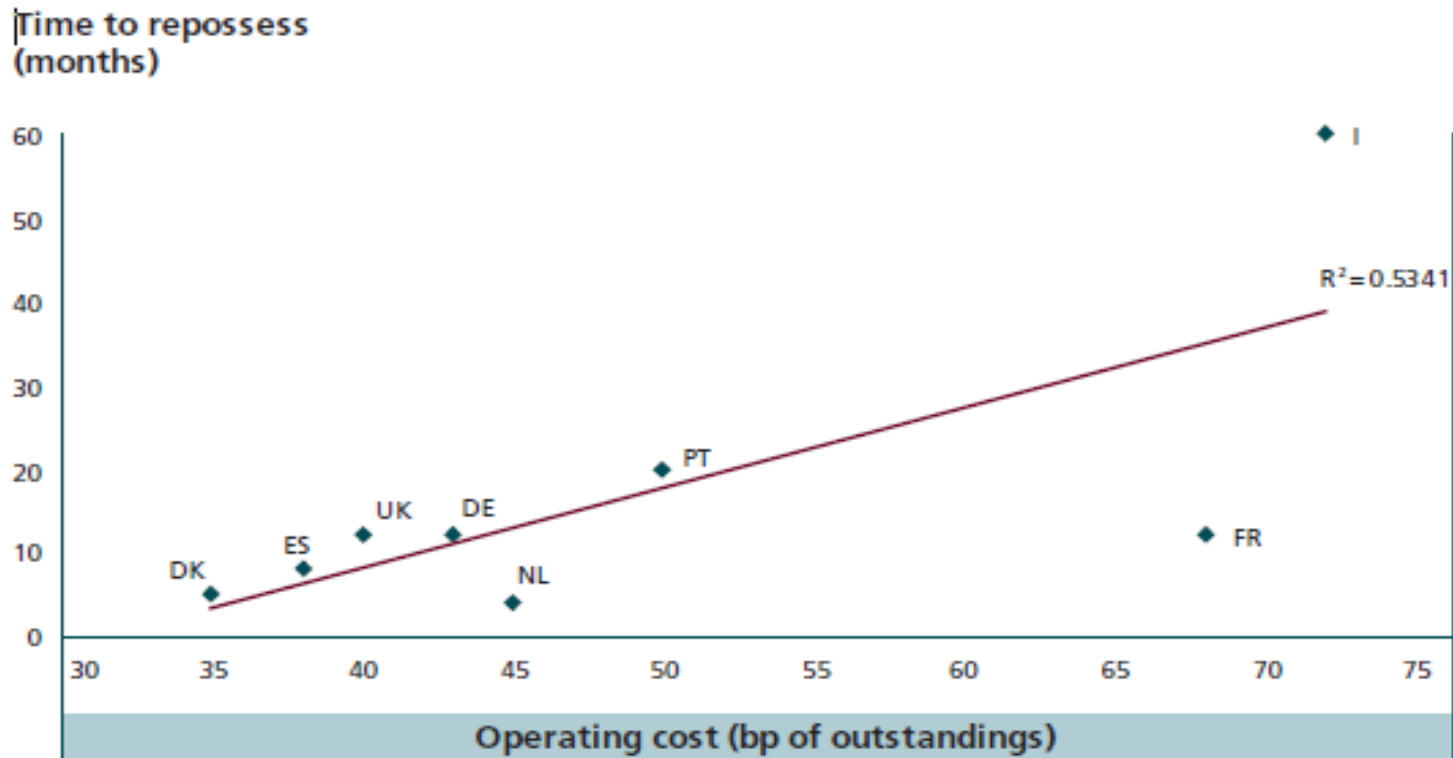
The Danish Mortgage Model

Assets	Liabilities
Loans	Bonds
Liquidity	Capital

Adjacent legislation

- The covered bonds programmes all over Europe build on ramified and comprehensive sets of legislation in each country
- A future covered bonds framework shall respect the differences in adjacent legislation
- This legislation is not necessarily explicitly relating to covered bond – but supporting the many aspects of a well-functioning, secure covered bonds programmes
- The adjacent legislation includes varied sets of regulation:
 - Insolvency regulation
 - Debt enforcement and the right to foreclosure
 - Rules governing land registration etc.
- How far we can take harmonization of covered bonds at present is probably to a high degree dependent on the adjacent legislation

Illustration of the impact on adjacent legislation



Source: EMF, Mercer Oliver Wyman

A future covered bond framework – preferential treatment

- A future covered bond framework shall ensure the status of covered bonds in European financial legislation
- Covered bonds in general have certain characteristics making them very secure and thus justifying preferential treatment for e.g. investment and liquidity purposes.
- Need to focus on these elements when considering an EU covered bond framework.
- What needs to be harmonised to justify the preferential treatment and make covered bonds eligible for all applicable prudential regulatory purposes?
- What is required to ensure the “covered bond brand”?
- Will harmonisation put the preferential treatment at stake?

Key questions to a future covered bond framework

- Important elements making covered bonds especially secure should be given special attention in a future framework
- Eligible cover assets
 - Aircraft, ships and SME loans...why or why not?
- Transparency in every aspect of the covered bonds programme
 - Disclosure towards covered bonds investors
 - Prices and repayment terms for the loans for the borrowers (important in match funding structures)
 - Basis for “market supervision”
- Enforceability
 - High standards for registration of mortgages
- Due consideration to differences between universal banks and specialises mortgage credit institutions in business models
- Due consideration to well-functioning nationally important systems

Closing remarks

- Covered bonds is crucial to the financial system in Denmark
- Can Europe change to the US way – or can covered bonds be the alternative?
- Crucial to maintain the high quality of the covered bonds and to ensure the preferential treatment
- A precondition for successful harmonisation is respecting the national differences and the well-functioning national systems