COMMENT

THE DANISH COMPETITION COUNCIL'S ANALYSIS OF THE MARKET FOR MORTGAGE CREDIT

DANMARKS NATIONALBANK

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The Danish Competition Council's report looks at some important competition issues in the existing structure of the market for mortgage credit. Danmarks Nationalbank finds it positive that the analysis brings into focus the question of how a basis for enhanced competition in this market can best be achieved.

The Competition Council concludes that the mortgage banks' direct competition with each other is only limited. The competition for borrowers mainly takes place in the banking market, where competition seems to be relatively weak compared with other countries. Against that background, the Competition Council presents a number of specific recommendations for improving the functioning of the mortgage credit market. Among these, the Competition Council points to various barriers for new participants wanting to enter the market and existing participants wanting to expand their activities. These barriers can be reduced. Overall, Danmarks Nationalbank agrees with these views. However, it is essential that the regulatory framework for the mortgage banks – and any changes to this framework – also support financial stability.

The mortgage credit system is a vital part of the Danish financial system, both in relation to property financing and due to the important role of mortgage bonds as liquidity and wealth instruments. When assessing how the interest of both competition and financial stability can best be taken into account, it is important to keep in mind that the mortgage credit system has inherent strengths and weaknesses.

From a borrower point of view, the system gives access to property financing on capital market terms. From an investor point of view, it gives access to bonds with low credit risk and high liquidity. Low credit risk and high liquidity are supported by a number of statutory provisions relating to, inter alia, the collateral behind the loans, procedural frameworks for debt collection if the borrower defaults, requirements for mortgage banks and requirements for bond issue sizes as part of the LCR rules.

On the other hand, it could be argued from a competition point of view that the mortgage credit system is based on the underlying prerequisite that each mortgage bank has a sufficient lending volume to give it substantial economies of scale. This allows the mortgage banks to issue bonds with high liquidity, while also offering a broad range of products. But as a result, the market for mortgage loans is currently split between very few mortgage banks, making it potentially difficult for smaller institutions to enter the market and to obtain a sufficient market share to be able to compete.

Besides the competition implications, there may be serious implications for financial stability when the mortgage credit sector is so large and concentrated. Hence, a situation where a mortgage bank experiences difficulties, including if the market starts questioning its robustness, will lead to a sizeable decline in the total credit supply. At the same time, the mortgage credit sector is closely interwoven with the rest of the financial system, in that other financial institutions use mortgage bonds as liquidity and wealth instruments. So if their value deteriorates, this will have a knock-on effect on the solvency and liquidity of the rest of the financial system. Furthermore, the mortgage banks all operate with more or less the same business model, meaning that they assume the same risks. If the market loses confidence in issuances by one mortgage bank, confidence in and thus funding for the rest of the sector may rapidly evaporate. Such situations may be unlikely to occur, but they are nevertheless still plausible, so it is necessary for the authorities to take them into account.

In Danmarks Nationalbank's opinion there are three elements of the regulation of credit institutions that are key to financial stability. The requirements laid down in legislation and by the Danish Financial Supervisory Authority as the supervisory and resolution authority should ensure: (1) that the institutions' capital adequacy is robust and appropriate; (2) that the institutions have stable funding; and (3) that they may ultimately be resolved without considerable negative consequences for financial stability and the economy.

All three elements are now regulated within the European framework for the single market. The ongoing work to establish a "single rule book", whereby financial institutions in the EU are subject to a single set of rules and harmonised supervisory practices, will create a basis for enhanced competition in the market for financial services. In Denmark it is particularly relevant that this contributes to strengthening competition between traditional mortgage loans offered by mortgage banks and mortgage-like loans offered by other types of institutions, including foreign institutions.

As stated by the Competition Council, it is also important to avoid unnecessary impediments to competition when the individual elements of the financial regulation are implemented – at EU level and nationally. In this context, Danmarks Nationalbank notes that the Danish mortgage credit system must essentially be subject to the existing and future European regulation as regards capital adequacy, stable funding and resolution without any special exemptions.

So Danmarks Nationalbank agrees with the Competition Council's recommendation that credible resolution plans should be in place for mortgage banks. In Danmarks Nationalbank's assessment, this would require an adjustment of Danish legislation to the effect that mortgage banks, like other large credit institutions in the EU, must have a sufficient volume of eligible liabilities (MREL). In a situation where a mortgage bank is no longer viable, it would thus be possible to write down the claims of shareholders and creditors or to convert them to equity (bail-in). This would ensure that there are sufficient funds for the bank to be recapitalised and for functions that are critical to society to continue – without affecting the mortgage bonds, which are unsuitable for bearing losses.

An MREL requirement on mortgage banks would also increase comparability and transparency, to the benefit of competition between Danish banks and mortgage banks and between Danish and foreign institutions.

Without the possibility of imposing an MREL requirement and using the bail-in tool, it would, in Danmarks Nationalbank's opinion, not be possible to solve the "too-big-to-fail" problem as regards the mortgage banks. It must be regarded as likely that the government would, instead, feel compelled to support a distressed mortgage bank, as winding-up under the current insolvency rules could be expected to have substantial negative implications for the economy and for financial stability. An implicit government guarantee of this kind also distorts competition since it gives mortgage loans an advantage, both over bank loans and over potential competition from abroad.

Moreover, the Competition Council points out that the Danish Financial Supervisory Authority's Supervisory Diamond for mortgage banks (enters into force in 2018 and 2020) will constitute supplementary Danish regulation, which may impede competition due to the fixed limit values for how a mortgage bank's lending portfolio may be structured and develop. Hence it is expected that the limit values of the Supervisory Diamond will be construed as actual requirements for the mortgage banks.

Both for competition reasons and in order to ensure a sufficient overall assessment of the individual mortgage bank's risks and risk management, it might be considered whether it is appropriate and proportional to fix such limit values for all institutions, irrespective of their capitalisation. In line with the Competition Council's recommendation, Danmarks Nationalbank finds it relevant to consider whether there are better ways to take these issues into account as part of the assessment of the need to set individual Pillar 2 requirements. This would also entail using a method based on EU regulation and applied in the rest of the EU to address the risks of the individual institutions, thereby supporting cross-border competition.

Such potential changes to the regulation of the Danish institutions should, however, be seen in the context of an overall assessment of how financial regulation, based on the above three key elements, supports financial stability.

Generally, Danmarks Nationalbank agrees with the Competition Council's recommendation that a thorough evaluation should always be performed to determine whether new financial regulation has negative implications for competition, and if so, whether the same aims can be achieved without impeding competition. That is a healthy principle, which Denmark should support in connection with the adoption of EU regulation, and which may also be taken into account in the Danish implementation of the rules.

All the same, there are areas where it is not possible to take all relevant factors into account. As examples of EU regulation limiting competition, the Competition Council points to the requirements for using IRB models as well as the LCR requirements for bond issue sizes. In both these cases, Danmarks Nationalbank finds that the regulation is appropriate and necessary in the interest of financial stability.