ANNEX

10. June 2016

Danish response to the consultative document on reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches

General Danish remarks

Denmark would generally like to encourage the Committee to consider the following:

- To reassess the need for output floors in light of other similar safeguards in the regulatory framework (e.g. the leverage ratio).
- To carefully consider the calibration of parameter floors and to abandon the use of floors on exposure level.
- To explicitly allow the advanced IRB approach for Income Producing Real Estate.

It is our view that these three changes would address the main Danish concerns while preserving the essence in the Committee's proposal. Hence, addressing these three challenges would be the Danish preferred way forward.

Alternatively, we encourage the Committee to consider a more nuanced approach. Following this, we would recommend a solution where the Committee's current proposal would more or less be implemented as is but where this would happen in combination with special treatment, e.g. less restrictive calibration, for demonstrably low risk markets and business models.

Particularly, we find that the differences between national housing markets are too substantial to warrant a one-size-fits-all approach. In our view there should be room for a more differentiated approach in this area, particularly considering the high importance of local housing markets to the different jurisdictions' economies.

In this respect, we find it prudent and appropriate to base such a more nuanced approach on quantitative criteria regarding the availability of long time series of low losses as well as more qualitative criteria regarding the functioning of the market. For example, we find that the exist-

ence/lack of full recourse is an important distinguishing feature between markets with different degrees of risk. Another important feature, in our view, is the degree to which an efficient liquidation process can be hampered by extensive consumer protection.

Specific Danish remarks

As already mentioned Denmark finds that the need for output floors should be reassessed in light of other safeguards in the regulatory framework.

However, should the Committee decide to introduce an output floor based on the revised standardised approach, we would find it prudent to consider a more nuanced approach. Specifically, we wish to encourage the Committee to consider lowering the risk weights for exposures secured by real estate in demonstrably low risk markets under the revised standardised approach.

Furthermore, the Committee proposes to set exposure-level floors on IRB-model parameters (PD, LGD, and EAD). We are not convinced of the merits of using floors on exposure level and we question this approach as it is solely targeting low risk exposures. Furthermore, it also distorts credit risk models' ability to correctly rank customers and exposures and consequently interferes directly in credit institutions' daily risk management. Portfolio level floors, as currently known for retail residential mortgages, would in our view be far less interfering although the calibration would still need to be carefully considered.

As mentioned in our main letter, it is our understanding that the proposal regarding Specialised Lending (SL) is based on concerns about the modellability of such exposures, for example due to lack of data or correlation between creditworthiness of the borrower and the value of the asset being financed.

There are five sub-categories in the SL segment, one of which is Income-Producing Real Estate (IPRE). While we acknowledge that concerns about modellability may be valid for some sub-categories of SL, we seriously question this concern when it comes to substantial parts of IPRE where Danish credit institutions are able to develop well-functioning models.

Data is widely available in the Danish mortgage credit institutions for some segments such as property rental exposures and exposures are relatively homogenous (possibly more than other corporate exposures). Likewise, it is our experience that concerns about correlation between borrower and the asset can be handled directly in the models.

Furthermore, in a Danish context large parts of the IPRE segment are generally low risk. Exposures are typically highly over-collateralised and in some cases there is also partial governmental support. Following this, we are overall concerned that the proposal will lead to an unwarranted increase in capital requirements, a loss of risk sensitivity and as a consequence incentivise credit institutions to shift their portfolios towards higher risk.

We therefore encourage the Committee to explicitly allow the AIRB approach for IPRE if the institutions can document the availability of sufficient historical data and fulfil all requirements for IRB modelling.

Alternatively, given the inherent low risk of many of the exposures in question we call for a less restrictive treatment under the standardised approach or the supervisory slotting approach. Again, such a change could be targeted at markets with demonstrably low risk.

The Committee's proposal contains a requirement that assignment to rating categories should remain stable throughout business cycles such that migrations are due to company-specific or industry-specific changes and not business cycles fluctuation.

We assume that the objective of this proposal is to achieve relatively stable capital requirements. However, we doubt that credit institutions will be able to comply with the requirement in practice as all the rating systems we know exhibit some migration over the cycle (e.g. when financial ratios change). On this background, we therefore encourage the Committee to consider a less prescriptive wording of the requirement.

The Committee proposes that exposures to corporates belonging to consolidated groups with total assets equal to or exceeding EUR 50bn should be subject to the standardised approach. We acknowledge the challenges to obtain reliable estimates of PD and LGD for corporates belonging to consolidated groups with total assets equal to or exceeding EUR 50bn due to the low-default nature of these corporations. However, using the standardised approach would mean increases in capital requirements which we do not find justified due to the same low-default nature of these exposures. We therefore encourage the Committee to reassess the need for using the standardised approach, and as an alternative consider the F-IRB approach for these exposures. In our view, using the F-IRB approach would be a way to preserve a risk sensitive approach but at the same time take into account that it can be difficult to obtain reliable estimates.

The Danish mortgage credit sector

As the proposal will significantly affect low risk market segments, including the Danish mortgage credit sector, we find it useful to briefly outline some of the special characteristics regarding this market.

The Danish mortgage credit sector is inherently low risk. This can be demonstrated by the empirical development as well as by the specific features of this sector.

Impairment charges for Danish mortgage credit institutions have averaged around 0.2 percent over the last 30 years. During the most recent financial crisis, which did affect the Danish economy severely, annual impairment charges did not exceed 0.2 percent. Please see figures A1 and A2 below for the development over an extensive time period.

Particularly worth highlighting, the mortgage credit institutions were able to increase their loan volume during the most recent financial crisis. Thus, the mortgage banks acted as an important stabilizing factor at a critical point where credit granting was otherwise contracting.

The historic performance of the mortgage credit institutions is not a result of chance, but due to the regulatory framework within which the institutions operate. Naturally, changes have been introduced to the framework over time – including introduction of new product types and removal of obligors' joint and several liability – but all in all Danish mortgage credit institutions have operated in a markedly low risk environment throughout.

Thus, while mortgage credit institutions must comply with the same regulation as all other credit institutions, they are subject to additional national requirements which set narrow limits for their business activities. In order to limit credit risk, mortgage credit institutions are only allowed to grant loans secured by real estate and only within specified loan-to-value limits. For residential real estate, loans can only be granted if they are within 80 % of the property value and for most other segments the equivalent limit is 60 %.

It is also important to highlight that Danish mortgage credit institutions have full recourse to all assets of a defaulting obligor and Danish obligors are thus personally liable for their debt. This provides mortgage credit institutions protection from losses beyond the risk mitigation originating from the collateral provided. Perhaps even more important, it additionally serves as a strong incentive for obligors to service their debt as nothing is gained from defaulting, even if the value of their property should fall below the value of the outstanding debt.

An additional feature of the regulatory framework surrounding the mortgage credit institutions is their very efficient access to liquidate the collateral in the event of default. Again, this provides a direct protection against losses, while incentivising the obligors to service their debt as it is not possible to prolong the liquidation process.

While not directly related to the proposal at hand, we would also like to further stress that the regulation of Danish mortgage credit institutions further ensures the low risk nature of the sector, e.g. effectively prohibiting mortgage credit institutions from taking significant market risk just as liquidity risks are very limited.

In addition, the legislation has in recent years been reinforced, limiting refinancing risk for the mortgage credit institutions' adjustable-rate mortgages. The legislation prescribes that bonds issued with a shorter maturity than the loans which they fund are automatically rolled over in the low-probability event where a refinancing auction of covered bonds related to the mortgage-credit institutions adjustable rate loans is unsuccessful, or if there's a steep, sudden rise in the bond interest rate.

As mentioned above, impairment charges have historically been very low for Danish mortgage credit institutions. Figure A1 below shows the low impairment charges of Danish mortgage credit institutions compared to those of commercial and savings banks. Over the last 30 years the average loan impairment charge for mortgage credit institutions has been 0.2 per cent while the corresponding average for commercial and savings banks has been 1.0 per cent. This period even includes two periods of financial distress as illustrated in figure A2 where real GDP growth and relative changes in house prices are added to figure A1.

Figure A1: Loan impairment charges for commercial and savings banks and credit institutions

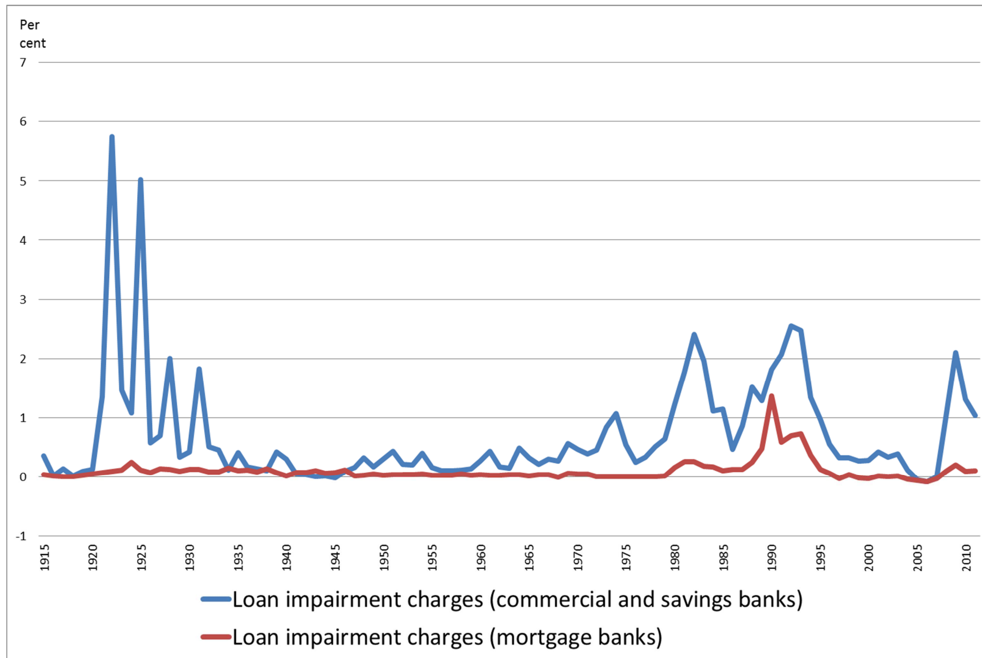

Figure A2: Loan impairment charges for commercial and savings banks and mortgage banks, relative changes in house prices, and real GDP growth.