DANMARKS NATIONALBANK

FINANSTILSYNET

To the Basel Committee on Banking Supervision

11 September 2012

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DANISH MINISTRY OF BUSINESS AND GROWTH

Danmarks Nationalbank and Finanstilsynet welcome the opportunity to comment on the consultative document on the fundamental review of the trading book. We support the efforts of the Basel Committee to ensure that financial institutions hold a sufficient amount of capital vis-a-vis institutions' risk positions.

Danmarks Nationalbank and Finanstilsynet agree with the Basel Committee that the definition of the regulatory boundary between the banking book and the trading book has been a source of weakness in the design of the current regulatory regime. We do, however, see some potential weaknesses in the proposed option of a valuation-based boundary. In particular, we are concerned that the proposed option of a valuation-based boundary might have adverse effects on the financial statements of financial institutions. In our view, the valuation-based boundary incurs a risk of not being able to reduce regulatory arbitrage in the current definition of the trading book and has the potential of disrupting accounting policies at the expense of a true and fair view.

From a Danish point of view this matter is of great importance as Danish mortgage banks measure mortgage loans at fair value through profit or loss in accordance with the so called "fair value option". The valuation-based approach implies that these loans should be included in the trading book and thus be risk-weighted under the rules on market risk even if all market risk is offset by the corresponding liabilities. The result would be risk-weighted assets much above what the actual risks would prescribe. If needed Danmarks Nationalbank and Finanstilsynet stand ready to provide further input on this specific problem.

Please see the accompanying note for a more detailed explanation of our concerns.

Yours sincerely,

Nils Bernstein

Ulrik Nødgaard

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Consultation on valuation-based boundary

Detailed comments on the proposal

From 1 January 2015 IAS 39 will be replaced by a new international accounting standard on financial instruments, IFRS 9. In the new standard the number of classification categories is reduced in order to reduce the complexity of IAS 39. However, the option to designate a financial asset or a financial liability as measured at fair value through profit or loss for the purposes of reducing "accounting mismatches" is carried on in the new standard. Furthermore, it is worth noting that the general criteria when determining whether a financial asset should be measured at fair value or at amortized cost will be based on the entity's business model as well as the characteristics of the cash flows of the asset; not whether the most predominant risk is market risk or credit risk.

Neither IAS 39 nor IFRS 9 restricts the use of fair value accounting to liquid held-for-trading assets that can be sold in the market or hedged within a very short time period. On the contrary, the accounting standards accommodate the use of fair value accounting for certain types of loans with long maturities. This is seen in the example of IFRS 9 B4.1.30 (c) which describes a situation where the use of fair value accounting eliminates or significantly reduces "accounting mismatch".

IFRS 9 B4.1.30 (c)
"An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other and the entity does not qualify for hedge accounting because none of the instruments is a derivative. Furthermore, in the absence of hedge accounting there is a significant inconsistency in the recognition of gains and losses. For example, the entity has financed a specified group of loans by issuing traded bonds but rarely, if ever, buys and sells the loans, reporting both the loans and the bonds at fair value through profit and loss eliminates the inconsistency in the timing of recognition of gains and losses that would otherwise result from measuring them both at amortised cost and recognising a gain or loss each time a bond is repurchased."[1]

[1] The example in IFRS 9 B4.1.30 (c) is carried on from IAS 39 AG4E (d)(ii).

The example in IFRS 9 B4.1.30 (c) refers to the exact characteristics of the Danish mortgage system. Danish mortgage banks finance mortgage loans by issuing traded bonds with matching characteristics. Both the loans and the bonds are designated at fair value through profit or loss in accordance with the fair value option. This ensures consistency in the measurement of the bonds and the loans while "artificial" gains and losses from regular repurchases of bonds are avoided. Thus through IFRS 9 B4.1.30 (c), the IASB encompasses the Danish mortgage system and provides a clear rationale for the use of fair value accounting for Danish mortgage loans.

As mentioned above, the mortgage loans are financed by issuances of bonds with matching characteristics. The loans can only be redeemed by buying the bonds in the market at market price or through an option for the borrower or the institution to redeem at par. It allows the borrower to buy back the specific bonds financing the loan in the market and deliver these to the mortgage bank as an early prepayment of the loan.

The value of the non-traded loan is thus directly connected to the value of the corresponding covered bond. An increase in the value of the bond means a corresponding increase in the value of the loan, and a decrease in the value of the corresponding covered bond means a similar decrease in the value of the loan.

The valuation-based approach implies that Danish mortgage loans valued at fair value would be included in the trading book and the loans would thus be treated under the rules regarding capital requirement for market risk using this approach.

The close relationship between the loans and the bonds, however, means that the changes in market risk of assets and liabilities are matched and the Danish mortgage banks are therefore to a very limited degree subject to market risk but however subject to credit risk.

Provisional calculations for a select number of institutions show that capital requirements based on the new method compared with the current IRB-treatment would rise with several multiples of the current capital requirements. In the view of Danmarks Nationalbank and Finanstilsynet the result of this method does not reflect the actual risks exposures.

Against this background, Danmarks Nationalbank and Finanstilsynet are concerned that the valuation-based boundary could have an adverse and unwarranted impact on the Danish mortgage system, either in the form of inappropriate capital requirements or in the form of potentially misleading financial statements. Therefore, we find that the valuation-based approach need further consideration and refinement, if the Basel Committee intends to continue down this road.