Realkreditrådet
ASSOCIATION OF
DANISH MORTGAGE BANKS

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To: The Basel Committee on Banking Supervision

7th. of September 2012

by email: baselcommittee@bis.org

Comments on the Basel Committee's consultative paper on a Fundamental Review of the Trading Book

The Association of Danish Mortgage Banks (Realkreditrådet) and the Danish Mortage Banks' Federation (Realkreditforeniningen) welcome the opportunity to share our views on such an important issue for the financial sector.

In the consultative paper as published on May 3rd, the Basel Committee (BCBS) proposes a valuation-based boundary for the trading book cf. page 17. According to BCBS, this approach would recognize the link between capital resources and capital requirements and attempt to more fully address the fact that market price changes in all instruments held at fair value immediately impact the solvency of banks.

We do not agree with the BCBS assessment that fair value designation necessarily implies market risk. It depends on the business model.

The Danish mortgage model represents a business model where fair value designation of mortgage loans does not imply market risk, that affect the solvency of the mortgage bank. Due to the pass-through system, market risk is born entirely by the mortgage borrowers and the bond investors. The mortgage banks effectively serve as intermediaries between bond investors and borrowers – whenever a loan is granted, the mortgage bank issues bonds in the market. The price the borrower ends up paying is the prevailing market interest rate on the bonds plus a fee to the mortgage bank. The one-to-one relationship between the granted loans and the issued bonds ensures that the mortgage borrowers and the bond investors bear all market risk whereas the mortgage banks only bear the credit risk associated with the loans. Hence, as the issued bonds serve as a perfect hedge, the fair valued mortgage loans only affect the solvency of the mortgage banks through credit risk – not by any market risk.

To ensure accounting consistency between the liabilities (the bonds) that are fair-valued instruments and the assets (the non-traded loans), IAS 39 9(b)(i) and IAS 39 AG4E(d) give the option to designate non-traded financial instruments at fair value when doing so reduces a measurement inconsistency. Accordingly, the fair value designation of Danish mortgage loans is only to ensure that no accounting mismatches are created that would otherwise arise when using amortized cost valuation.

We therefore strongly prefer a final document that allows fair valued financial instruments to be allocated to the banking book, if the business model design implies that the financial instruments do not exhibit any market risk that affect the solvency for banks.

The fundamental review of the trading book should produce a system which is simple and implies comparable allocations of instruments to the different books across banks, cf. page 14.Treating non-traded mortgage loans as trading positions would conflict with both of these objectives.

Treating mortgage loans as trading positions would have dramatic unintended consequences for Danish mortgage banks. The credit risk on the loans would have to be treated as specific risk in the trading book, and not as credit risk in the banking book according to the IRB-approach used by most Danish mortgage banks The specific risk approach uses external credit ratings as an important input. For most mortgage loans to retail customers and small businesses, no such external credit rating is available, implying a risk weight of 100 percent. The effect on capital requirements would be massive. Depending on portfolio characteristics, capital requirements would be increased by a factor of 2 to 5, if mortgage loans were to be allocated to the trading book.

The Danish mortgage system has been based on the one-to-one relationship since it was established more than 200 years ago. The one-to-one relationship is one of the key elements of the unique Danish mortgage model that has ensured some of lowest loss rates ever experienced in covered bond markets In addition, the system was able to issue covered bonds on a continuous basis during the financial crisis in 2008 to the benefit of Danish households and businesses.

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We would be pleased to elaborate on our comments, if so requested.

Yours sincerely

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Annex

Danish mortgage banks fund a specific group of loans by issuing listed bonds. The fair value changes of the loans and bonds offset each other. Further, Danish mortgage banks buy and sell these bonds on a day-to-day basis. Recognising both the loans and the bonds at fair value through profit or loss in the financial statements, eliminates the inconsistency in the timing of the 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. Since the adoption of IFRS in 2005, Danish mortgage banks have therefore used the fair value option to value the issued covered loans (the asset) and the issued listed covered bonds (the liability) according to IAS 39 9(b)(i) and IAS 39 AG4E(d)(ii). This treatment ensures that no accounting mismatches were created by IAS 39.

The Danish mortgage system is based on a one-to-one relationship between Danish mortgage banks' lending and issued mortgage bonds. This implies that the mortgage bank only funds loans by selling bonds with matching characteristics and that bonds can only be redeemed when a borrower decides to redeem a loan. This is done by either the borrower or the mortgage bank buying the bonds in the market. This close relationship ensures that changes in market risk of loans (assets) and bonds (liabilities) are totally matched keeping the capital level of the mortgage bank unaffected. This construction eliminates all market risk for the mortgage banks. Therefore the Danish mortgage banks are only subject to credit risk.

A change in the loans (assets) market risk and value will therefore have a corresponding effect on the market price of the bond. The reason is that the change in value of the loans will be offset by the opposite change in the bond price. The IAS 39 and the possibility of fair valuing both the asset and the liability ensures that there is no accounting mismatch.

The Danish mortgage system

Danish mortgage banks are specialised banks, which only grant loans against mortgages on real property by issuing covered bonds. Loans are granted at loan-to-value (LTV) ratios of up to 80% for private residential loans and typically up to 60% for other purposes, including commercial purposes. Mortgage banks have only one source of funding: bond sales. Thus, a mortgage bank does not operate in the same way as a commercial bank, which may take deposits or raise money market funding.

As the mortgage system is based on a principle of matching, all loans are matched with certain bonds (see chart 1). The loan type, repayment profile, term and currency thus determine which bonds the mortgage bank will sell. This ensures transparent loan costs, market-based prices, and unique prepayment options for borrowers. The match funding principle applies to all loans. In connection with adjustable-rate mortgages, the maturity of the underlying bonds is generally shorter than the loan terms. Here the match funding principle applies to the individual interest periods between refinancings. When the loan is refinanced, the underlying bonds are replaced. Further, the adjustable-rate mortgages are

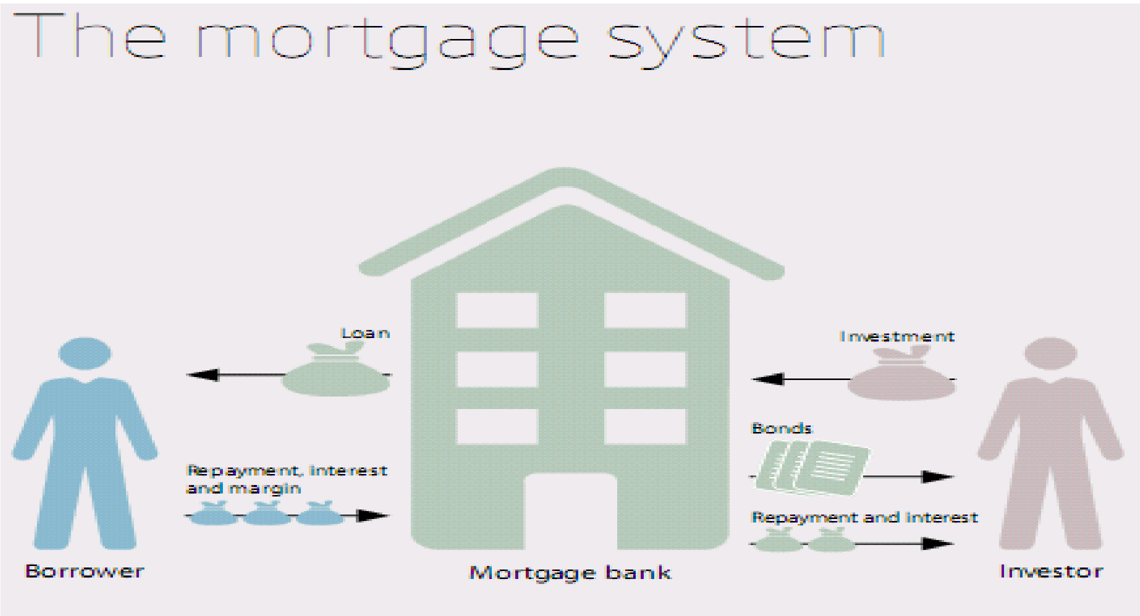
constructed in a way that ensures that the borrower (and not the mortgage bank) has the full refinancing risk – any change in interest rates is fully transferred to borrower.

All loans are funded on a current basis (tap issuance). That is, the mortgage bank issues the required bonds at the same time the loan is disbursed to the borrower. The prevailing market price consequently determines the loan rate faced by the borrower. In addition to the interest payment on the bonds, total costs also include a fee to the mortgage bank covering daily operating expenses and loan losses. Borrowers know which bonds fund their loans. As the bonds are listed on a stock exchange, borrowers can easily monitor market trends and thus the price they are paying. Borrowers may always prepay their loan by buying the underlying bonds in the market – this option is frequently used when market prices are in the favour of the borrowers.

Mortgage loans remain on the balance sheet of the issuing mortgage bank until maturity. The mortgage bank thus carries the credit risk on the loans until they mature. The mortgage bank thus have strong incentives to closely monitor the credit quality of its portfolio. In case of a loan defaulting, the mortgage bank will claim the underlying collateral (the real property). Danish law ensures a fast foreclosure process implying that the mortgage bank can easily access the collateral. Further, the borrower is subject to so-called full recourse liability which means that the mortgage bank can maintain a claim on the borrower, in case the realization of the collateral results in a loss for the mortgage bank.

The covered bond market plays a very important role in the Danish economy due to its size. By end of July 2012, outstanding covered bonds amounted to EUR 367 corresponding to approx. 150% of Danish GDP. In comparison, outstanding government bonds amounted to EUR 105bn. The Danish covered bond market is Europe's third largest with the German Pfandbrief market as the largest and Spain as the second largest.

Chart 1



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