Realkreditrådet
ASSOCIATION OF
DANISH MORTGAGE BANKS

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To: The Secretariat of the
Basel Committee on Banking Supervision

by e-mail : baselcommittee@bis.org.

The regulatory framework: balancing risk sensitivity, simplicity and comparability - response

The Association of Danish Mortgage Banks (Realkreditrådet) appreciates the opportunity to comment on the Basel Committees views on the recurring task of ensuring an appropriate balance between risk sensitivity, simplicity and comparability in the Basel III framework.

We support the aim for a balanced and multifaceted regulatory approach and share the conviction of the committee, that a risk-based capital regime should remain at the core of the regulatory framework. We further support the proposals for more benchmarking of risk-weighted assets across financial institutions that will help enhance transparency.

Against this backdrop we must, however, address our concerns regarding certain elements proposed in this discussion paper. Specifically, the introduction of a uniform non risk-based leverage ratio as a Pillar I requirement will in particular act as a binding restriction for genuine low-risk business models. To avoid serious unintended consequences, such leverage ratio requirement should be considered with due care so that it does not end up being counteractive to the risk-based regulatory approach. The leverage ratio should act as a backstop against excessive leverage – not as the main binding operational constraint for low-risk business models.

The Danish mortgage model represent a business model that may be harmed unintentionallly by a uniform leverage ratio limit. Intriguingly the Danish mortgage model is characterized by market based transparency and thus a high, but comparable, risk sensitivity which sustained activity and ensured relatively low borrowing costs throughout the recent financial crisis.

Subsequently we would like to present the characteristics of the Danish mortgage model and elaborate on the problems related to the elements mentioned.

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Characteristics of the Danish mortgage model

Danish specialized mortgage banks operate subject to a specialist banking principle confining the activity of mortgage banks to mortgage lending based on mortgage bond funding. Under the principle mortgage banks are prohibited from collecting deposits. This principle is instituted in Danish legislation because mortgage bond funding is generally considered the most stable.

Mortgage loans remain on the balance sheet of the issuing mortgage bank until maturity. The mortgage bank thus carries the risk on loans until they mature. The mortgage bank thus has 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 system has worked for 200 years, and loan losses have been less than 1% of total lending by Danish specialized mortgage banks, including commercial lending, even during the worst crisis in the 1930s. During the recent financial crisis – following considerable declines in property prices and GDP – the loan loss level, including commercial lending, has been modest at 0.2% annualized.

Leverage ratio

Specialized mortgage banks with low credit risk and low financial risk on lending and funding are most likely to be affected under a system with a fixed leverage ratio. A "one-size-fits-all" fixed leverage ratio does not take into account tightly regulated lending limits, low credit risk as a result of solid security in the form of mortgages on real property and low financial risk due to a pass-through balance principle.

A fixed leverage ratio would either render specialized mortgage banks uncompetitive because of very high capital costs relative to competitors – or would encourage specialized mortgage banks to assume significantly increased risk.

Consequently the leverage ratio should not be rigidly applied as an extra capital requirement, but may be a useful tool in the assessment of a financial institution along with the risk-adjusted solvency level.

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We highly approve on your willingness to commence industry comments at this early stage. We remain at your disposal for any questions or requests for additional information regarding any of the comments set out in our response.

Best regards,

Jan Knøsgaard

Deputy Director General