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FINANCE DENMARK

Revisions to the minimum capital requirements for market risk

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Finance Denmark is a business association for banks and mortgage institutions in Denmark. Our members are mortgage institutions, banks, savings banks, cooperative savings banks and Danish branches of foreign banks.

Finance Denmark appreciates that the Basel Committee has decided on a review of the new framework for minimum capital requirements for market risk. In our view, the new sensitivity-based framework represents a significant improvement compared to the existing framework. However, introducing a completely new framework will inevitably require adjustments to certain parameters and to certain elements of the overall structure of the framework, to appropriately reflect the risks involved and to facilitate a smooth functioning of the framework for all types and sizes of bank.

The European Banking Federation has commented in detail on a broad range of issues covered in the consultation document. Our comments below supplement the EBF response to the consultation on aspects of the review of particular importance from a Danish perspective.

Proportionality
We appreciate that the Committee has chosen to retain the Basel II standardised approach (subject to appropriate high-level recalibration) as the simpler alternative for smaller credit institutions with limited trading book activity. This will save considerable investment for smaller banks in developing a new simplified method in an area of limited importance for these banks. We also welcome that the criterion to apply the simplified standardised approach will not be based on a specific prescribed threshold on the size of the trading book in absolute terms and relative to total assets. Due to LCR regulation, small and non-complex banks may hold considerable positions in LCR securities - over and above 5 or even 10 per cent of total assets - that are traded regularly and therefore liable to be categorised as trading book positions. Therefore, some flexibility is needed for competent authorities to assess the appropriateness for smaller banks to apply the

simplified approach. It is important that the simplified standardised approach for market risk is calibrated carefully compared to the new standardised approach to ensure that there are appropriate incentives for banks to invest in developing a more risk sensitive approach but at the same time not unduly penalising smaller banks for which the investments required to develop and operate the more advanced risk sensitive approaches would be disproportionate to their trading activity.

Credit spread risk weights for covered bonds

We are surprised that the review and recalibration of the risk weights of the new Standardised Approach does not include a revision of the risk weights for credit spread risk for covered bonds.

In the new Standardised Approach investment grade covered bonds[1] receive a 400bp risk weight for credit spread risk. This is slightly less than the 500bp credit spread risk weight assigned to "Financials" non-securitisation issuances that do not qualify as covered bonds, but much higher than the risk weights assigned to other investment grade industry sector risk buckets and investment grade securitisations (RMBS).

We believe it is important that the framework is calibrated in a way that accounts for important structural elements within the covered bond frameworks that set these assets apart from other asset classes. Covered bonds are secured by a preferential right to assets in the cover pool which are typically ring-fenced, and further claims (not covered by the cover pool) can also be made against the issuer's total assets. This means in practice that covered bonds have "double" security. Typically, they are also governed by separate and strict legal risk management requirements, covering credit risk and sometimes also market risk. We have not seen evidence for the calibration of the credit spread risk weight in the new Standardised Approach. Indeed, the risk charge for credit spread risk for covered bonds appeared for the first time in the final standard published in January 2016 without having been subject to prior consultation.

The table below compares the historical largest credit spread moves for investment grade issuances in the different sector buckets for non-securitisation with the assigned credit spread risk weights in the Standardised Approach. This shows that the assigned risk weights for credit spread risk in the Standardised Approach reflect the actual maximum historical credit spread moves over a 40-day holding period over 10 years quite accurately. This is in sharp contrast to covered bonds, where

[1] Covered bonds that meet the definition provided in paragraphs 68, 70 and 71 in the following publication: Basel Committee on Banking Supervision. Standards Supervisory framework for measuring and controlling large exposures. April 2014, www.bis.org/publ/bcbs283.pdf

the credit spread risk is around 4 times the maximum historical 40-day credit spread moves.

Comparing the Standardised Approach credit spread risk weights to (historical) worst 40-day credit spread moves observed on various sector indexes/issuances.

Sector Bucket	Index	Largest historical 40-day credit spread move	SBA CS risk weight	SBA CS risk weight vs largest historical CS move
Financials, Investment Grade	JP Morgan US Financials (Spread to Libor)	490bp Since Jan. 2006	500bp	1.0x
Non-financials, Investment Grade	JP Morgan US Non-Financials (Spread to Libor)	293bp Since Jan. 2006	150-300bp Average: 238bp	0.8x
Covered Bonds Investment Grade	Nykredit DK(1) DK	83bp Since 2002	400bp	4.8x
	Realkredit Dan-mark (1) DK	114bp Since 2002	400bp	3.5x
	Nordea (1) DK	100bp Since 2002	400bp	4.0x
	SEB(2) SE	85bp Since 2002	400bp	4.7x

1-Spread between the 10Y-point on the Nykredit, Realkredit and Nordea mortgage curve and the 10Y-point on the DKK benchmark swap curve.

2- Spread between the 5Y-point on the SEB mortgage curve and the 5Ypoint on the SEK benchmark swap curve.

Source: Danske bank, Bloomberg

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This illustrates that the 400bp risk weight for credit spread risk applied to high quality covered bonds under the Standardised Approach requires a substantial adjustment to be more reflective of their true risk and to resolve inconsistencies in the treatment of the different asset classes within the framework.

Given the evidence provided as to the structural features of the covered bond markets and historical data, and to address the inconsistencies in the treatment of different asset classes across the Standardised Approach, a credit spread risk weight of 100bp for investment grade covered bonds seems reasonable.

Liquid FX pairs

We welcome the revisions proposed in the consultation document to allow banks to combine two currency pairs in the list of liquid pairs and threat the resulting new FX pair as liquid. We also welcome the reduced risk weight to be applied to the FX risk class. However, the proposed treatment does not in any way recognise the effect of fixed exchange rate mechanisms that set narrow limits on the maximum variation as, for example, the agreements governing the Danish Kroner and Euro exchange rate. An EUR/DKK position will be assigned the same risk weight as any non-liquid currency pair, despite that the actual historical DKK/EUR exchange rate fluctuation around the central rate has never exceeded +/- 1% since the Euro was launched in 1999 and stayed within the +/- 0,5% band since July 2003.

Liquid currency areas and risk weights for general interest rate risk
In connection to the proposed revised risk weight for general interest rate risk under the standardised approach we would ask the Committee to consider a possible additional amendment.

For interest rates risk under both the IMA and SA, a preferential treatment is given to a bank's domestic reporting currency. Interest rate risk in a bank's domestic (reporting) currency is considered to belong to the most liquid (10-day) bucket under IMA and under SA receives a reduction in the risk weight by dividing the risk weight by the square root of 2. We support this rule.

However, the rule may inadvertently penalise banks operating with a significant presence in several jurisdictions and (home) currencies and, in doing so, create a barrier for international and pan-European banks to have significant participation in certain markets. This is especially the case for the non-euro EU markets. For example, a bank whose reporting currency is DKK would be able to put DKK interest rate risk in the 10-day liquidity horizon bucket under IMA, while a bank whose reporting currency is EUR or SEK (even those with significant presences in the Danish market) would have to put DKK interest rate risk in the 20-day bucket. This creates an un-level playing field among market participants and may directly lead to a reduction of liquidity in these markets.

We therefore suggest giving national competent authority the opportunity to permit a bank domiciled elsewhere to classify the local currency as "domestic" currency, provided that the bank fulfils certain criteria which may include access to liquidity with the local central bank as well as a sufficient large presence in the local interest rate risk market.

PD floor - Default risk charge under the IMA
We realise that the Default Risk Charge (DRC) under the Internal Model Approach (IMA) is not part of the present consultation. Nonetheless, we find it important to stress that the 3-bp floor on probabilities of default (PD) that was introduced in the market risk standard from January 2016 may have an unjustified

large impact on capital requirement associated with market making and thus impact the liquidity of the Danish sovereign and covered bonds market and negatively impact funding costs.

Sovereign exposures and high quality covered bonds are held by banks for several different purposes that are primarily linked to the management of their liquidity and to their business with clients. In addition, where a bank is a primary dealer or a market maker, inventories are held in accordance with anticipated near-term client demand. The 3bp floor on PD is overly conservative for AAA rated government and coved bonds. In so far as a non-zero floor is deemed appropriate, a PD-floor of 1bp for AAA rated bonds would still be conservative but reduce the potential harmful effect on liquidity and funding cost compared to the proposed floor of 3bp.

Kind regards

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